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FEDERAL, STATE, AND LOCAL GOVERNMENT FISCAL RELATIONS

LETTER

FROM THE

ACTING SECRETARY OF THE TREASURY

TRANSMITTING IN RESPONSE TO

S. Res. 160

A REPORT SUBMITTED TO THE SECRETARY OF THE TREASURY BY A SPECIAL COMMITTEE DESIGNATED TO CONDUCT A STUDY ON INTERGOVERNMENTAL FISCAL RELATIONS IN THE UNITED STATES

JUNE 23 (legislative day, MAY 24), 1943.—Referred to the Committee on Finance and ordered to be printed

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TREASURY DEPARTMENT

THE COMMITTEE ON INTERGOVERNMENTAL FISCAL RELATIONS

HAROLD M. GROVES
LUTHER GULICK
MABEL NEWCOMER

Special Advisors

ROY BLOUGH
L. LASZLO ECKER-RACZ
CLARENCE HEER
CARL SHOUP

Full-Time Staff

WILLIAM B. GATES, Jr.
ARCHIE B. GOODMAN
RUSSELL J. HINCKLEY
HERBERT E. KLARMAN
LOREN D. MELTON

Contributing Staff

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NEIL H. JACOBY
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SIDNEY SCHMUKLER
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C. LOWELL HARRISS
LUDWIG S. HELLBORN
E. GORDON KEITH

Administrative Assistants

FLORA S. ALEXANDER
DOROTHY T. GIBLIN

LETTER OF TRANSMITTAL

TREASURY DEPARTMENT,
Washington, June 23, 1943.

The PRESIDENT,
United States Senate.

MY DEAR MR. PRESIDENT: Pursuant to Senate Resolution 160, there is transmitted herewith a report on fiscal relations of Federal, State, and local governments prepared and submitted by the Committee on Intergovernmental Fiscal Relations which was appointed in June 1941, to study this problem.

Very truly yours,

D. W. BELL,
Acting Secretary of the Treasury.

For sale by the Superintendent of Documents,
U. S. Government Printing Office, Washington, D. C.
Price 75 cents

LETTER OF SUBMITTAL

The honorable the SECRETARY OF THE TREASURY,
Washington, D. C.

SIR: In June 1941, the Secretary of the Treasury took steps to reexamine the problem of Federal, State, local fiscal relations. Study already given the subject by the Department over a period of several years made it clear that a vigorous and comprehensive inquiry was called for by a staff freed from all other responsibilities within the Department. Accordingly, a small temporary research staff was assembled under the direction of the undersigned committee. The chief of staff has been Dr. Harold M. Groves, who was released for this undertaking by the University of Wisconsin. The work was carried out partly in Washington in the Treasury Department's Division of Tax Research and the Bureau of Internal Revenue, and partly in the field in cooperation with State and local governments. The project was financed in part by special funds provided for this purpose by the Congress. The committee was fortunate in having at its disposal the aid of the Institute of Public Administration, made possible by a grant to the Institute by the Carnegie Corporation to carry through such parts of the work as could not appropriately be financed from Federal funds.

The committee wishes to express its appreciation first of all to you and to your responsible officers who organized, supervised, and encouraged the inquiry in every possible way. Mr. Roy Blough, Mr. L. Laszlo Ecker-Racz, and Prof. Carl Shoup of the Division of Tax Research counseled and assisted the committee during the several stages of the project. Next our appreciation is due the able and devoted staff which took part in the study. We are also indebted to other governmental agencies, particularly the Department of Commerce and the Federal Security Agency.

While this study was made within the Treasury and with the extensive help of responsible officers of the Treasury, the report itself represents the findings and recommendations of the committee and must not be taken in any way as presenting the views of the Department.

The conclusions of the committee are presented in summary in our Intergovernmental Fiscal Relations—Major Conclusions and Recommendations and in more extensive form in our report. In addition the committee is issuing a number of special studies prepared for the committee by selected authorities. The conclusions presented in these studies are those of the authors alone and do not necessarily reflect the views of the committee. The committee is, however, indebted to these authors for their contributions and is issuing their reports so that others may have the benefit of their valuable work.

In common with everything else this study has been deeply affected by the war. Anticipated researches which would have enriched our knowledge were dropped or never initiated primarily to free manpower for the war. And in certain areas war problems have doubtless deflected our attention from what is, after all, a permanent aspect of the American federal system. For these reasons our report concerns itself both with the intergovernmental fiscal problems of the war and with the underlying permanent problems.

Respectfully submitted.

HAROLD M. GROVES.
LUTHER GULICK.
MABEL NEWCOMER.

OCTOBER 15, 1942.

S. RES. No. 160, 78TH CONGRESS

(Submitted by Mr. George)

June 22 (legislative day May 24), 1943.

Resolved, That the Secretary of the Treasury be, and is hereby, directed to transmit to the Senate a report on fiscal relations of Federal, State, and local Governments submitted to the Department of the Treasury by a special Committee on Intergovernmental Fiscal Relations appointed by the Secretary.

Attest:

Secretary.

PREFATORY NOTE

This report was well under way before the United States entered the war. It is based on the assumption that the United States will be on the winning side of the war and that the struggle will not be so long and exacting that all our institutions will need to be revolutionized to conform to military necessity. Considerable attention has been paid to the modifications in intergovernmental relations which have grown out of or which can be foreseen as likely to grow out of the war. But the report is not primarily concerned with these problems. It has taken cognizance of the war up to the present, but it is conceded that rapidly changing military events may make any long-range program propounded in the summer of 1942 quite antiquated soon after it is formulated.

Plans for a more comprehensive study with more original research were abandoned because of the war.

In the following statement of major conclusions and récommendations, the first main section is concerned with the general approach to the problem. The remainder of the statement contains the more specific recommendations. These recommendations are summarized in terms of action programs for each level of government at the end of the statement.

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MAJOR CONCLUSIONS AND RECOMMENDATIONS

I. Emphasis and Approach

1. EMPHASIS UPON COOPERATION

Coordination and cooperation rather than subordination and coercion is the answer to intergovernmental fiscal problems in the United States.

Our Federal system with its present division of power and responsibility is supported not only by tradition and legal precedent but also by widespread recognition of the very real values of decentralized government. The system permits adaptation of legislative programs to widely divergent conditions, interests, and points of view, which is very important in a large country; it provides room for experimentation in government; it encourages participation in government, and with it the development of sounder civic attitudes and better trained leadership; and it narrows the scope for the inefficiency and red tape that often occur in a huge bureaucracy. Coordination has become a major problem in the operation of the Federal Government.

The superior strategic position of the Federal Government in the control of large-scale business, in the stabilization of employment and production, and in the maximization of national income has justified aggressive Federal leadership and the expansion of Federal activities in recent years. But this expansion need not be at the expense of the States and the municipalities. The major consideration is how best the States may participate in this expansion, and how best they may facilitate rather than retard it. The States still continue to retain large responsibility for many governmental services close to the welfare of the citizen. The Federal Government has a vital interest in maintaining and strengthening both State and local governments. Much valuable energy has been wasted unnecessarily in quarreling over the proper spheres of the Federal Government and the States, when the seeds of solid achievement lie in the scantily tilled field of intergovernmental cooperation and coordination. Progress in this field requires some willingness to compromise, to surrender vested interests, and to forget jealousies on the part of both the Federal Government and the States.

A change in attitude of revolutionary proportions seems to be needed. The American governmental system has not been viewed as a unit by most public officials, with loyalties evoked and encouraged for the entire system. If the mayor of a municipality believes that a change in the Federal income tax would embarrass his own government, he is likely to feel no great concern as to whether the change is needed to strengthen and equalize the Federal system of personal taxation. Federal administrators show equally unfortunate blind spots. Very often they lose, in addition, a proper sense of proportion, and conclude that all wisdom and authority are concentrated in Washington. State officials who object to this frequently show the same attitude in dealing with municipalities. Some of this is but the inherent limitation of human beings. But much of it could be eliminated by more conscious effort.

Recent decisions of the Federal Governments of Canada and Australia to federalize a large part of State tax systems for the period of the war place proponents of our overlapping tax system on the defensive. Conditions in these two Federal systems differ somewhat from our own. These countries, in contrast to our own, have a highly developed tradition of allowances (fixed grants) from the central government to the divisions. State tax rates, particularly in the income-tax field, were substantially higher for at least some of the foreign states than for our own. The tradition of local and State autonomy was probably less highly developed. Certain coordination devices, notably income-tax deductibility, were more highly developed in this country than in the British federations, but others, such as joint administration, were much less developed. Of course, even if there were no difference in conditions, it could not be concluded from these examples that the States should be excluded, in effect, from important tax fields even during the war emergency. Fiscal independence is a large sector of general independence, and the latter a large part of local self-government which, in turn, has important democratic values. It has been suggested that another major war might put an end to Federal systems everywhere. Whether or not this be true, it appears that a large degree of State and local fiscal independence does carry values of a very high order, and that they should not be sacrificed until the necessity is clearly demonstrated. It is not believed that this is yet the case.

That State rights should yield to military necessity will be generally conceded. That the war effort would be served by federalization of State revenue systems is, however, very doubtful. The Federal Government has enough on its hands for the present without assuming the responsibility for State finances unless this course would yield very important advantages in ordering its own financial program. That there would be some advantages may be conceded, but at present and in the near future these advantages seem outweighed by the disadvantages.

2. THE PRAGMATIC APPROACH

An analysis of the history of the fiscal coordination movement in the United States, and of the experience in other countries, suggests that a pragmatic approach to the problems of intergovernmental fiscal relations is likely to be the most fruitful. The pragmatic approach does not exclude the necessity of some analysis of long-run principles and interests. However, hopes for a solution of the fiscal coordination problem, or for a comprehensive single plan for immediate adoption, are doomed to disappointment. Some scholars have rejected the idea of "nibbling" at the problem, bit by bit, as entirely inadequate, but it is this unspectacular method that promises most in the way of progress in what must be a cooperative venture. Indeed the preoccupation of the critics with grandiose plans for fiscal coordination may account for the rather low score of achievement to date.

A federal system involves at least two layers of government, which necessarily draw upon the same economy for support. It is almost inevitable that no matter how carefully drawn a constitution may be, some overlapping and conflict will ensue. Each authority tends to guard its own sphere of activity jealously and to resent encroachment by the other.

Under these conditions there can be no completely logical and clear-cut solution of fiscal problems. The united and uniform fiscal system of which some administrators dream is possible only in a unitary state. The best that can be achieved in a federal-state is a working compromise, even as the federal-state itself is, in its origin, a compromise.

It needs always to be remembered, also, that all movements toward coordination involve, to some extent, a choice of values. Coordination aims at uniformity, and finds one of its principal causes for action in the compliance costs and irritations associated with diversities of State laws and practices. But these diversities can be defended, too, as experiments in new and different techniques or adaptations to different conditions. Those who dislike centralization think of uniformity as vicious rather than beneficent; they apply the adjective "deadly" to what the centralizers seek. Here, as in many other matters of social policy, it is not possible to have one's cake and eat it too. It may be possible, however, to achieve some results without great loss of values. There are areas in which diversity serves no useful purpose.

A survey of foreign experience indicates that no federal form of government has developed an entirely satisfactory method for coordinating its fiscal system, much less a single panacea. Examples of almost all the coordination devices can be found in foreign experience, the selection and pattern depending considerably upon historical accident. What has worked well in one country has not always been successful in another. Australia has achieved notable success in cooperative administration, one of the less spectacular approaches to the problem, but there is no certainty that this would be equally successful under other conditions.

In short, the problems are presented and the recommendations are made in such manner that any one part is only a short step forward on the road of advancement; but if progress is likely to be slow and difficult, it is not on that account necessarily less important.

3. THE COORDINATION MOVEMENT

The history of the fiscal coordination movement is characterized by much frustration, wishful thinking, and rationalization, but the efforts expended have brought to public attention a set of problems that are real and urgent. The movement has been led mainly by State officials, with less active participation by scholars and businessmen. It has not been supported by any ground swell of popular interest, and the lack of participation of farm and labor groups is conspicuous. There has been no crystallization of opinion concerning the problems involved, even among the experts. The movement has often failed to come to grips with fundamentals; a customary procedure has been to endorse the word "coordination," hand it to a committee, which also endorses it, delivers a few generalizations, and recommends "further study." (It must be conceded that as to some of these limitations the present report is no exception.) There has also been a conviction that a group of specialists could draft a formula or set of specifications to satisfy all parties when, as a matter of fact, many of the issues involved are beyond the province of the expert. If the time should ever arrive when Congress would feel it necessary for the Federal Government to take over the major strategic revenue sources of the States and put these governments on an allowance, no extensive study would be required to tell it how or why.

But this is not to say that the movement has failed to accomplish a useful purpose. It has called attention to real and urgent problems growing not only out of the overlapping tax system, but also out of the increasing national economic integration and interdependence. The development of huge corporations, only a little if at all less powerful than the States which charter them, and the growth of interstate trade, travel, communication, and migration, have intensified problems of multiple taxation, allocation, interstate competition, and costs of administration and compliance. One writer goes so far as to express the view that "commerce renders the mere convenience of uniformity [in laws] an almost imperious necessity." Tendencies toward instability and insecurity, coupled with increasing economic capacity, have developed an interest in over-all fiscal planning. These are only a few of the many reasons for concern about a revenue system that has developed piecemeal and is largely uncoordinated.

In the course of the history of the coordination movement, most of the principal devices for coordination have been recommended for adoption or extension. These include separation of sources, joint administration, State supplements to Federal taxes, credits, sharing of revenues, Federal and State grants-in-aid, and reallocation of functions. All these devices have been tried either in this country or abroad. Experience suggests that no one of them will achieve desirable results under all conditions. The means must be adapted to the nature of the problem for each tax or expenditure, and for each country.

4. GENERAL POSITION OF THIS REPORT

This report seeks a middle ground in the coordination problem. On the one extreme are the strong centralizers, who feel that State and local fiscal independence has served its usefulness and is no longer compatible with modern economic facts. The report of the Canadian Royal Commission goes far in this direction. At the other extreme are those who are satisfied with what we have and who argue that the frictions and wastes of uncoordinated taxation are the necessary price which we wisely pay for our Federal system with its large measure of local freedom. Both of these groups are more realistic than the hybrid school which hopes for a completely coordinated fiscal system with no shift in the division of governmental powers.

The centralization of all the major taxes in the hands of the Federal Government would provide a simple, logical, orderly, and well-coordinated tax system. The centralization of the major service functions would avoid the confusion of transfers of money and would enable the application of receipts where they are most needed. Together these steps would enable us to dispense largely with some 165,000 units of government. They would give the Federal Government quite ample fiscal powers to deal with our unstable private economy. But there is no assurance that the resulting unwieldy machine would not have worse internal incoordinations and inefficiencies than the external ones so apparent in our present makeshift arrangements. And the loss in intangible values might be even more serious.

But we think that there is another and sounder middle ground, which accepts the framework of the American governmental system and seeks no large shift in the division of power. This view starts with the observation that Federal-State relations have been marked by coolness, distance, suspicion, and jealousy. Governmental problems in our modern era have become so large and vital, and participation in a united attack upon them is so essential, that a new attitude, facilitated by new institutions, should be the minimum acceptable program of fiscal modification. While much weight needs to be given to the values associated with autonomous local government, these have to be balanced against the advantages, such as reduced confusion and wider perspective, which attend central control. A priori generalizations concerning centralization are of little use. Each specific problem has to be considered on its own merits. In some cases federalization of a function may (by a balance of the interests) be warranted; in others, retention of the function by States and municipalities may be called for; and most often joint participation, in one way or another, may be the best solution. Decentralization within the sphere of Federal activities may also have a place in the picture. The presumption should probably favor decentralized control but it is by no means a final or conclusive presumption.

This approach to the problem calls for a high degree of genuine mutuality. State suspicion that intergovernmental cooperation will be mostly Federal domination must be dispelled. A program of full and genuine mutuality is entirely possible.

The middle way which we have sought to follow has some claim to acceptance as the American way. American belief in the dispersion of initiative and in safety of numbers is very deep. The pragmatic approach, adapting machinery to the necessities of time and place, is also American in tone. Finally, the views here taken—that private enterprise should be encouraged, not hampered, in carrying as large a share of the future economic load as its performance will justify; that government, nevertheless, must be relied upon to insure an end product in security and well-being compatible with a developing social conscience—these, too, are a part of the American tradition.

II. Plan for a Federal-State Fiscal Authority

5. FEDERAL-STATE FISCAL AUTHORITY

It is recommended that a Federal-State Fiscal Authority be created. This is in line with the general approach here taken, namely, that the problem is not likely to be settled all at once, but that constant study of and readjustment in intergovernmental arrangements will be necessary; also, that the keynote in intergovernmental relations should be cooperation rather than subordination.

A Federal-State Fiscal Authority could be expected to perform the following functions:

(1) Promote close collaboration among State and Federal administrators with the objective of joint administration of selected overlapping taxes. Administrators have made some progress toward coordinated tax administration, notably in making Federal income-tax information available to the States. Also in the liquor tax field, collaboration of State and Federal officials is highly developed and has proved mutually satisfactory. However, efforts to devise and inaugurate a joint return for Federal and State income-tax reporting have proved abortive. Recent experience with the Federal automobile-use tax warrants the conclusion that effective Federal-State cooperation in administration cannot be improvised, but requires extensive negotiation and preparation. A Federal-State Fiscal Authority would be admirably suited for this role.

The administrative approach to the problem of coordination is likely to prove the most fruitful one in the case of net income taxes, business taxes, sales taxes (if the Federal Government enters this field), and possibly death taxes. Joint returns, joint audits, and joint use of administrative personnel offer possibilities for future development.

Much could be said for an Authority which would administer overlapping taxes directly. The experience of Australia, which has made greatest progress in the administrative approach to the coordination problem, points toward a joint administrative agency. But Australia's problem is simpler than that of the United States. The Commonwealth has only 6 states and their revenue systems are more important relatively than those of our 48 States. (The latter factor creates a more even balance of power than that which exists in the United States.) Eventually a Federal-State Fiscal Authority of the type here recommended might be given power to administer some taxes in its own right. But at the outset its role had best be confined to that of mediation between Federal and State officials. It should be observed, however, that joint administration is not Federal administration; a large factor of mutuality is implied.

(2) Facilitate interstate cooperation. For example, working with existing agencies, the Authority could promote reciprocity legislation, as in the licensing of out-of-State trucks.

The Council of State Governments, among others, has perceived for some time that a much greater degree of interstate cooperation is required to maintain our Federal system in a healthy condition. Some of the gravest problems in the field of intergovernmental relations might be solved if there were a sufficient degree of interstate cooperation. Of all the remedies for these many problems, interstate cooperation ranks first in its promotion of the prestige and independence of the States. But interstate cooperation, to function most efficiently, needs a "friend at court" within the Federal Government. And it needs an easy vehicle of transition from the field of interstate to that of Federal-State cooperation. A Federal-State agency should supply the factors needed to lift interstate cooperation to a much more active and more useful plane.

(3) Act as a clearinghouse for proposals relating to Federal payments in lieu of property taxes on federally owned property. In the past, legislation in this field has followed no consistent principles, and an unduly complicated pattern of procedure has developed.

The Authority might also serve as a "board of appeals" to hear complaints regarding Federal payments in lieu of taxes, and the use of taxation or other instrumentalities as trade barriers.

(4) Conduct research. Evidence of high costs of excessive tax machinery, both to governments and to taxpayers, is sufficient to warrant much more intensive study than the subject has thus far received. It is surprising that almost no evidence is available concerning the compliance costs of our social-security system with its substantial reporting requirements. Similarly, only scattered and inconclusive evidence is available concerning the effects on firms engaged in interstate business of diverse apportionment formulas applied under income and business taxes. Little convincing evidence is available concerning differential tax burdens as a factor in industrial location and relocation. These fields could be cultivated to excellent advantage, either directly by, or through the stimulation of, a Federal-State Fiscal Authority.

(5) Create public interest in intergovernmental relations. Public apathy does not signify that the problem is unimportant. That the public (except certain classes of taxpayers seriously inconvenienced by duplication) has never been much interested in the "frictional expense" involved in taxation (cost of administration and compliance) is evident enough from the paucity of data concerning these costs. Public concern in these matters, however, can and should be developed.

(6) Disseminate among the States information on Federal taxes and economic trends as they affect the States.

(7) Promote better governmental reporting, accounting, and statistics.

As to organization, it is suggested that the personnel of the Authority consist of one member appointed by the President, one selected by a conference of delegates named by State Governors, or through some other method satisfactory to the States, and one named by these two, all to be suitably qualified in the field of intergovernmental fiscal relations. Terms might be staggered, and of 4 years' duration; offices should be located in Washington.

This commission of experts should be assisted by a representative council. Intergovernmental cooperation is not likely to develop very far except through the process of a meeting of a large number of minds. Representation and conference are the essence of this procedure, and either by legislation or working rule, a Federal-State agency program should include an advisory council. The council would provide a means of getting a consensus. It should afford direct representation of congressional committees and recognized organizations of State and local and Federal officials. Further representation for municipalities might also be secured by a provision requiring that one of the three experts be especially informed on municipal affairs.

It is proposed that $150,000 to $200,000 be authorized as the initial budget of the Authority and that half of this fund be appropriated by the Federal Government without any contingent (matching) provision, the other half to be raised from State legislatures through the Governors and their delegates. It is recognized that the process of raising financial support in the States will involve delay and uncertainty. The Federal share should be sufficient to enable the Authority to make a showing.

The plan of organization here proposed contemplates that as soon as the Authority has been authorized by Congress and the Federal appointee has been named by the President, the latter should call upon the States to designate their appointee. The selection might be made through a conference of delegates named by the Governors. A plan for financing the State share of the Authority's cost would also be adopted by this conference. A fair method of distributing the States' share would be in proportion to the amounts of State and local taxes raised. This outline of procedure is suggestive only. One alternative method would be to provide for selection of the States' representative by the Governors, the choice of a method of selection being left to the Governors.

The impression should not be conveyed that the development of administrative collaboration is impossible without a Federal-State agency. Much cooperation could be achieved without any institutional changes. New interest and a new cooperative attitude would be sufficient. But a Federal-State agency should help to develop this new outlook, and the latter might not be forthcoming without some new factor of the kind suggested.

The idea of a Federal-State Fiscal Authority is not new or original. It has been endorsed by a large number of organizations and individuals, and as an antidote to interstate trade barriers has received strong support from high-ranking Federal officials. In our opinion it would go far toward assuring that continual progress in this field of intergovernmental fiscal relationships which, under modern conditions, is becoming more and more necessary.

III. Independent Sources of Local Revenue

6. INDEPENDENT SOURCES OF LOCAL REVENUE

It is recommended that major attention be given to a reorganization of the sources of local revenue, particularly city revenue, in such manner as to preserve and restore local autonomy, and to enable local governments to tax their own resources, according to their own discretion, without the development of more overlapping in taxation. This, in our opinion, calls for a bold attack and some fundamental changes in a time-honored institution—the general property tax.

There can be little doubt that local governments, particularly city governments, are "in a bad way" from the fiscal standpoint. The recent depression caught them ill-prepared; many were obliged to borrow heavily to meet current expenses, and the refunding of maturing obligations was common. The spectacle of a city like New York, popularly regarded as the "gold coast" of a rich country, going through one financial predicament after another, obliged to adopt a sales tax, which its mayor had successfully attacked in Congress, and frankly conceding its future dependence on Federal revenues, is evidence enough that something is lacking in local revenue institutions. New York's financial problem is not unique. Most cities have been living from hand to mouth in the hope that something would turn up. And the attitude of municipal officials has grown increasingly pessimistic. One of them writes that "in the field of taxation the city is practically powerless" and has been placed in a "financial and administrative strait-jacket"; another deplores the fact that "municipalities are facing a post-war period when local governments will find it necessary to more and more go to the central government for Federal assistance with its resulting placing of control."

No doubt much of the blame for these predicaments can be placed at the door of the States in whose legislative councils cities have for years been under-represented. Cities have often shared very inadequately in newly developed State revenues, particularly in motor-vehicle tax revenues. More important, the States have undermined and strait-jacketed general property tax expansion, both with exemptions and with ceiling limitations.

The cities in some instances have their own mismanagement to blame for part of their financial troubles. But the generally rising competence of officials in posts of municipal responsibility has been one of the bright spots in the recent evolution of American Government. It may well be that "the best managed of our cities are ahead of the Federal Government in the quality of their administration."

The cities have claimed the privilege, and some have found it possible, to develop some diversification of revenues. And so we find, for example, municipal sales taxes in New York and New Orleans; a flat earned income tax in Philadelphia; a license tax based on volume of business in Louisville and Richmond; a 1-cent gasoline, 1-cent bottle beer, and 2-cent cigarette tax in Birmingham; and gasoline, automobile-license, and cigarette taxes in Kansas City. But these developments involve piling taxes three deep in a number of cases, and they represent at best additional complications in a revenue system already highly complicated.

A major cause of the failure of municipal revenues on the score of adequacy is the unpopular general property tax. Although this tax proved the mainstay of local support for many years, it broke down badly during the recent depression and is under incessant political attack by State and local leaders. Beside many traditional faults, which need not be recapitulated here, the property tax, like the income tax, is attacked because its base is too narrow. The property-owning lower middle class resent what they regard as the tax-free status of the "proletariat." This attack gains strength because of the traditional interest in widespread home ownership. Finally, the property tax is resented because of its regressivity, the fact that it falls with greatest weight on relatively poor taxpayers.

The narrow jurisdiction of the municipality makes it essential to depend on a relatively immobile tax base for the major part of local revenues, and this points to the continuance of the largest part of the local tax burden on real estate. But there are important possibilities of redistributing this burden among individual owners of real estate and their tenants.

What is needed, apparently, is some new source of local revenue which will (1) not overlap existing Federal and State taxes, (2) enable the localities to tap their own resources without running hat in hand to central governments, (3) cover all or a vast majority of the interested citizenry, and (4) not be regressive. This is no easy assignment but the following suggestions are recommended for consideration.

The property tax might well be broken down into its elements and its uniform application to all owners on the basis of holdings be abandoned. One way of recasting the fragments would contemplate a collection from landlords in the nature of a service charge for local benefits to property, and a further collection, more personal in character, from occupants on their rental value of occupancy. The occupancy tax could be added as either a replacement or a supplement to the general property tax; and it might be introduced step by step on a gradual and experimental basis.

The property tax has suffered from notoriously weak administration. But the best possible assessment would fail to reach the shortcoming of market value as a measure of tax paying ability. It may be conceded that the owner of real estate producing no current income has some tax paying ability. But it may still prove awkward to obtain the necessary cash for tax payments; and more important, the expected future income on which the market value is based may never be realized.

In view of these limitations a good case can be made for shifting a part of the burden from real estate to current income, that is, the gross rental value of occupied premises. It may not be desirable to reduce current levies, in view of the fact that these may be partly capitalized, and that there is no certainty that the owner would reduce rentals to his tenants if such a change were made. But where there is need for more municipal revenue, a city might well give consideration to a tax on rentals, collected from the occupier. One advantage of such a tax is that, being in proportion to current income rather than expected future income, it will spread the burden over the various parcels of real estate in a different manner from the tax on capital values. Unused properties would be exempt. Also, the distribution between tenants and landlords would vary, since there is always some friction in the process of shifting. Finally, a rental tax could make some allowances for individual ability to pay. The tax on home rentals might be adjusted to take account of size of family, and a progressive rate might be imposed. This would tend to offset the regressive tax on capital values. A business rental tax would be levied, of course, at a flat rate.

Among the objections to a supplementary rental-value tax would be the necessity for two valuations—rental value as well as capital value. This is not a simple problem, since many properties are occupied by their owners, and in other cases the actual rent paid must be adjusted to allow for special circumstances.

There are other objections to a rental tax. For instance it would offer no answer (except in its possible feature of graduation) to the criticism that much of the weight of the local tax system falls on housing, an area of expenditure in which the nation is trying to improve standards. Some concessions to housing, probably confined to the philanthropic element in public housing, may be necessary. It is quite possible, too, that an occupancy tax might increase the cyclical fluctuations in city revenues. Nevertheless, the frequency with which such taxes have been used by other countries suggests that they have possibilities that may well be explored.

Other ways of reaching the property base are the use of unearned increment taxes and the further development of special assessments. The latter have sometimes been used to excess, and the record of administration is not encouraging, but many cities have failed to develop their possibilities adequately. Many municipal services yield special benefits, and the cost might reasonably be covered in this way.

Some municipalities could revise their public utility charges, also, to cover costs, or even to contribute to the general treasury.

While the retail sales tax as a local revenue source is quite objectionable because of its overlapping of central sources, its regressivity and its jurisdictional complications, nevertheless it may be worth considering as a last resort. Exemption of food might reduce regressivity and some city might test the practicability of a personal exemption under this form of tax. As against the steady and extensive surrender of local fiscal independence, the city sales tax might merit further consideration.

In any event, the municipality should be given greater freedom in the application of the general property tax. Rate limitations offer no constructive solution to the problem of financing local government or improving the property tax. Their proponents are indifferent to fiscal crises and counsel a resort to any action other than an immediate increase in real-estate taxes. The right of the cities to tax their own citizens as they please within the property-tax area, primarily suited for local exploitation, should be generally restored, subject only to rules supplied by the State as to the general framework. Administrative assistance from the central units need not be precluded by such a development.

Property-tax exemptions have been too freely granted and too generously interpreted. Effective State supervision of property-tax administration, or State assessment if such central assistance cannot be developed, is needed to offset the pressure of special local interests. Nowhere in the whole field of intergovernmental fiscal relations are there greater opportunities of improvement than those of the States and localities involved in the administration of the property tax. In cooperativeness of attitude, adequacy of assistance, and techniques of procedure, improvements of revolutionary proportions are possible and imperative. Even the Federal Government has proved helpful in this field, as in Pennsylvania, where the George-Dean Act appropriations have been used to develop scientific assessment data.

The widely prevailing notion that the general property tax, except for new exemptions and rate limitations, is a crystallized institution and fixed for all time should be exploded. Whether or not these specific proposals are received with favor the whole subject of independent local revenues should be given fresh and bold reconsideration.

The Federal Government is in the best strategic position to cope with cyclical emergencies and should, even with a strengthening of local financial independence, continue to finance employment-creating improvements during such periods. Moreover, as subsequently elaborated, the Federal Government should enlarge the number of functions in which, because of a national interest, Federal support is given through grants-in-aid. Federal payments in lieu of property taxes on federally owned property, such as housing, should be more generous and dependable. A Federal market for municipal bonds might be helpful in time of depression, but the major need is for a source of revenue which will enable the localities to tax their own resources independently. Much of the vitality of local government in the United States depends upon the development (discovery and utilization) of such a source.

IV. Coordination of Specific Taxes

7. INCOME TAXES

Coordination in Federal and State income taxation is of first-rate importance for it is in this field that multiple taxation, threatened (and perhaps actual) interstate migration, and high compliance costs are particularly prominent.

Substantial coordination in the net income tax field has been achieved through the device of allowing the State income tax as a deductible expense in calculating the Federal tax, with mutual deductibility in some States; more can be achieved by the development of cooperative techniques in administration, with the State tax becoming more and more a supplement to the Federal tax. The States should not be asked to surrender the income tax; unless interest in State and local government is to be discouraged, some access by the States to progressive, personal, and direct levies is exceedingly important. But the States should surrender exclusive control of jurisdiction (that is, the determination of what is within the territorial province of each State to tax), and mutual adjustments should be made to attain more uniform State and Federal laws. The fear of migration of taxpayers, which has impeded the development of State income taxes, might be checked by an income-tax credit (permitting a part payment of Federal taxes with State tax receipts), but this is hardly politically feasible with only about two-thirds of the States levying income taxes. The deductibility provisions perform the same service to some degree. Spotty State administration could be strengthened under the cooperative program outlined above.

The State net income tax encounters serious impediments of conflicting jurisdiction, multiple taxation, high compliance costs, uneconomical administration, and interstate competition. There are antidotes for all these limitations and none is so serious as to warrant a death sentence for the State income tax. It is true, of course, that the State income tax does less to "correct" geographical maldistribution of income than the Federal. The Federal tax, coupled with a well-ordered system of Federal aids, would be most effective as a corrective for such geographical maldistribution. This device is now being applied to some extent, but imperfectly; it can be further developed and improved to relieve the pressure for new revenue for State and local tax systems. But this does not mean that the States need to be ruled out of the income-tax field.

The present provisions, which permit income taxes paid to States to be deducted in computing net income for Federal tax purposes, and the reciprocal practice, in more than two-thirds of the income-taxing States, allowing Federal tax payments to be deducted in computing net income for State tax purposes, exclude the ordinary possibility of the combined Federal and State tax rates becoming confiscatory except in cases where incomes or tax rates have fluctuated greatly from year to year. These practices have the further effect of reducing substantially the differentials in burdens among taxpayers living in different States. This acts as a curb to tax avoidance by migration, a fact which has received little recognition. For example, if each government allows the deduction of taxes paid the other, the combined load of an 80 percent Federal and a 15 percent State rate is only 80.7

percent (77.3 percent Federal and 3.4 percent State). Even in the absence of State provision for the deductibility of Federal tax payments the existing Federal provision allowing the deductibility of State taxes substantially reduces the variation in income taxes paid by taxpayers in income tax States and in nonincome tax States. While at the lower levels of income the effect of deductibility is less conspicuous, the same general relationships apply. At the $5,000 income level, the differential in total income taxes between a New York and non-income-tax-State taxpayer (1942 rates) is 1.1 percent of net income and 14.7 percent of the total tax of the latter taxpayer.

Because of the deductibility feature of Federal and State income tax laws, the Federal Government can and should feel free to order its wartime and post-war income tax schedules without much regard to the present State levies or possible changes in the latter.

The deductibility provision in the Federal law not only protects the taxpayer, but also gives a substantial advantage to income tax States in that the Federal Government collects substantially less from the taxpayers of such States than from those with equal incomes (before taxes) in other States. The advisability of this "subsidy" may be questioned, but the deductibility feature applies equally to most taxes and may be supported, in addition, on the ground that it encourages the States to maintain progressive elements in their tax systems. It is true that State provision for deductibility of Federal taxes tends to make the State income tax less progressive, but the resultant combined Federal and State tax liability may more closely represent popular intent than would be the case were deductibility disallowed by the States.

Much can be said for an amendment to the Federal law requiring reciprocation by the States as a condition of Federal deductibility for State taxes. However, at present levels of taxation such a program would involve the risk, were States to fail to meet the condition, of a confiscatory combination of rates. For this and other reasons, the reciprocity condition is not recommended for adoption. It is recommended that, as soon as revenue needs permit, States which do not now allow reciprocal deductibility change their statutes, to allow it.

While deductibility is a fairly effective protection against an excessive combination of State and Federal rates, it is by no means perfect. It gives less relief to corporations than to individuals. It works quite badly in the case of irregular income and in years when the tax rates are changed. To mitigate the difficulties arising from these changes, it is recommended that taxpayers be allowed to report taxes on an accrual basis even though other expenses are on a cash basis. This would mean that the taxpayer in his Federal return could report his State income taxes due and payable at the time of reporting rather than the cash outlay for income-tax purposes during the previous year.

The most promising approach to further coordination of net income taxes is in administration. A sound precedent for delegated administration has evolved in both Canada and Australia, and the development of joint administration has been suggested as an improvement upon these successful experiments. Utilization by the States of Federal income-tax information is already developed to some extent and some informal cooperation between administrative staffs now occurs. But the field has scarcely been scratched. Joint returns, joint audits, joint use of personnel, and more uniform laws are a few of the possibilities. As previously suggested, a Federal-State Fiscal Authority could be of immense usefulness in paving the way for this program.

The possibility of State supplements (or additions) to the Federal income tax is one that has frequently been proposed. The supplementing program contemplates a high degree of uniformity and joint or delegated administration. It is a goal toward which it is possible to work by degrees.

Multiple taxation is a serious problem in the income-tax field. It occurs in the case of the corporation tax because of diversity in States' procedures of apportionment. Here fairly well recognized standards of fair practice have been worked out and the problem is to secure wider State acceptance. In personal taxation the problem is not so serious, but there is no generally accepted basis of proper procedure. Almost any generally applied standard would be a great improvement over the present situation and would largely remove multiple taxation. Jurisdictional conflicts constitute a problem in which the Federal Government is most strategically situated to make decisions. The rules that should be applied and the means of promoting them must remain somewhat vague for the present. But the outlines of a desirable procedure are fairly clear. They call for (1) conference and consultation between Federal and State officials as to acceptable uniform jurisdictional rules; (2) joint promotion of the adoption of these rules; (3) acceptance of Federal arbitration in cases of dispute; and (4) Federal development of incentives for State compliance. The Federal Government should gradually develop techniques to purchase compliance with such rules regarding jurisdiction as it may establish, in consultation with the States. The price might take the form of free access to information and other administrative services for States that are willing to cooperate. Perhaps stronger economic incentives would prove necessary and could eventually be developed.

There is no easy solution of this difficult problem, but the above approach has the advantage of offering a way for gradual progress toward the desired goals by the use of democratic tools—negotiation, persuasion, and compromise. A mutual attack on the problem can be carried on without the bitterness which Federal imposition of standards might entail. Here again the Federal-State Fiscal Authority would be almost a condition precedent to worth-while accomplishment

8. DEATH TAXES

Federal and State death taxation is frequently cited as a field in which some coordination has already been achieved, particularly through a credit to the taxpayer against his Federal tax for death taxes paid the States. Inaugurated in the middle twenties, this device consists of an allowance up to 80 percent against the Federal tax as computed under the 1926 Federal estate tax. The Federal law has since been amended several times, and the rates revised upward and the exemptions downward, but the credit is still tied to the antiquated 1926 law. The credit does not apply to the Federal gift tax, inaugurated in 1932; a similar tax is now included in the inheritance tax systems of 12 States. At the very least the credit should be adapted to the most recent estate tax statute, with applicability in terms of the present rates and exemptions, and to the taxation of gifts. Better still, the entire estate tax system should be overhauled; Federal exemptions should be reduced to at least the average level of State exemptions (the present Federal estate tax exemption is $60,000; the gift tax exemption, $30,000); the estate and gift taxes should be integrated; and the crediting program should be brought into accord with current Federal practices. Going further, the credit, as explained later, should be broadened in an effort to eliminate dual administration and multiple taxation.

On strictly logical grounds a very strong case could be made for separation of sources as a coordination device in the death tax field. If this were recommended, the Federal Government would be the choice as the taxing unit. The State tax is plagued by interstate competition and multiple taxation, and especially by the fact that estates are highly concentrated in a relatively few States, though the wealth represented may have been accumulated over a much wider area. On the other hand, the States, with one exception, have a proprietary interest in this field and any proposal for surrender would arouse intense antagonism. Moreover, any method of "getting the States out of the field," short of a constitutional amendment, would involve a distribution of revenues not very different from the present. The credit is now the accepted device for coordination in the field, and it can be remodeled to accomplish much wider objectives than those which were contemplated in the original effort.

The credit has been fairly effective in the elimination of interstate competition, but it has largely failed to mitigate the conspicuous problems of dual administration, multiple taxation, and excessive diversity that characterize our overlapping system of death taxation.

In modernizing the credit, the law might be changed to allow the taxpayer a credit of 50 percent of the tax (at 1941 rates and assuming a $20,000 specific exemption) on the amount of the estate not exceeding $100,000, and a credit of 25 percent of the tax on the amount of the estate exceeding $100,000. This would enable the States to enact minimum estate tax laws to cover their entire inheritance tax schedule. Most of them would gain by such action in all brackets of the tax. (This is on the assumption that the Federal Government would also substantially reduce its exemptions.) Perhaps the greatest weakness of the present credit is that it requires dual administration. States are required to build up the taxpayer's liability to the State before the Federal credit is applicable. But the Federal Government could and should assume the task of determining the taxpayer's liability to the States. Or better still, this matter could be handled by joint administration. The main difficulty in this program is the question of State jurisdiction to tax. But this is a matter which the Federal Government ought to arbitrate in the interest of all concerned. The right to determine jurisdiction might well be imposed as a condition under which the Federal Government would offer its administrative services to the States. Going further, it might also be imposed as a condition for the credit itself.

State death taxation has long been harassed by dispute concerning the taxpayer's domicile and the courts have failed to assist in clearing the field of "double domicile." Other cases of multiple taxation, particularly in the taxation of intangibles, are fairly common and destined to become more so. The Supreme Court, in recent decisions, has shown an inclination to reject the role of arbitrator in these disputes. It is doubtful whether this multiple taxation is helpful to anyone, and it provides an indefensible penalty from the point of view of the cosmopolitan taxpayer. The Federal Government, through the the use of persuasion, sweetened with the advantages that it can offer the States, should seek to clear the field of these vicious anomalies. A liberal tax credit could be used effectively toward this end.

State administration of the inheritance tax is spotty, and in general the field is one of neglect and confusion. Legal and lay authority, and State and local responsibility, are mixed in a variety of patterns. The administration is frequently relatively expensive and otherwise unsatisfactory. Administrative collaboration with the Federal Government would probably improve the product considerably.

It has long been recognized that in spite of some very stiff rates and occasionally onerous burdens imposed by the Federal estate tax law, the results of the death tax system are fiscally disappointing and its incidence highly capricious. For example, the owner of an estate of $100,000 can still make a tax saving of over 90 percent by disposing of half of his estate through inter vivos gifts. The death tax field needs a thorough overhauling along lines previously suggested. If the job is done thoroughly, death taxes can be made to assume a place of prominence in the tax system commensurate with their inherent merits.

9. TOBACCO TAXES

The taxation of tobacco products has gradually become heavily involved in our overlapping tax system. The Federal Government has been in the field uninterruptedly since the Civil War, and 29 States are now included in the tobacco tax family, the number having more than doubled in the last 11 years. (However, it should be observed that State taxes on tobacco are very largely cigarette taxes; for example, only 9 States tax cigars.) In addition, a considerable number of municipalities tax tobacco. The tax is becoming increasingly popular as a source of State revenue, and it seems but a matter of time before the tax will be universally applied at the State level. The tax is admirably adapted for Federal collection and State sharing, and while this device is open to general objection in its curtailment of State independence, its application in this instance would have so many advantages that it is recommended at least as an experiment.

State administration of the tobacco tax has important inherent limitations. In the first place, such administration is necessarily decentralized and considerably more expensive than Federal administration. The use of stamps applied to the outside of cigarette packages is relatively expensive. The States, in addition, give discounts to the tobacco merchants as an allowance for expense of affixing stamps. These discounts often run to 10 percent or more of the value of the stamps. More important is the substantial avoidance of State tobacco taxes by interstate purchase. This leakage is prevented only to a limited extent by the use tax. Extensive cooperation by Federal postal authorities in the case of parcel post shipments does not appear feasible as a corrective. Joint administration in this instance is not practical, for the two governmental levels mainly involved make their collections from different distributors, the Federal from the manufacturers, the State largely from the wholesalers. When all the leaks and costs are considered, administration of State tobacco taxes is probably only from 70 to 80 percent effective. This is surely a situation which calls for some kind of action.

The sharing device is well adapted to application in the tobacco tax field also because the diversity in State laws, while substantial, is not as great as in most other State taxes. The State rate of 2 cents per package on cigarettes, for instance, is preponderant. Moreover, a formula of distribution should not be too difficult to agree upon. A per capita distribution, with perhaps a 150 percent weighting to urban population, would approximate relative amounts of consumption and could be simply applied. The field is not one in which the maintenance of State discretion as to rate and administration should be regarded as of great significance.

As is usually the case in sharing proposals, the problem arises as to the loss of revenues of States and municipalities now employing rates above the average. To meet this, it is recommended that all States be allowed their present collections (including municipal collections) or their pro rata share of the distribution, whichever is higher. Provision might be made for a gradual transition to general sharing on the formula basis, the transition to cover a period of perhaps 10 years. The entire program would not involve a very difficult adjustment for either the Federal Government or the States.

More specifically, it is recommended that the Federal tax on cigarettes be increased to the extent of 2 cents per standard package and that the share of Federal revenues represented by this portion of the tax be distributed to the States on a per capita basis (with due regard to the urban factor as indicated above). The distribution would be conditional upon State and municipal withdrawal from the field. Similar arrangements should be made with regard to other tobacco products. A minimum but gradually vanishing guarantee should be included to safeguard State and local revenues. If this program were inaugurated in an era of declining Federal tax rates, State distribution might be substituted for an otherwise contemplated rate decrease for the Federal tax.

10. LIQUOR TAXES

No new major coordination devices are here recommended for the liquor tax field except the continuation and extension of that general forbearance and due regard for each other's taxes that the Federal Government and the States should practice at all times. The liquor tax field is characterized by such diversity of legislation and administration, based upon geographical differences of opinion as to proper taxation and regulation of liquor traffic, that it would be unwise to attempt a uniform national program. Our experience with uniformity under national prohibition was not a happy one. Moreover, the opportunity to establish a uniform system with Federal collection and State sharing came squarely before the country in 1934 and was quite definitely rejected. It can be said, however, that the considerable use by the States of their wide regulatory powers over liquor importation, to establish barriers to interstate trade, is an unfortunate development. This phase of the problem can and should be attacked by State reciprocal legislation, and by educational work sponsored by the proposed Federal-State Fiscal Authority and the Council of State Governments. Abandonment of Federal license taxes (as distinguished from excises) would relieve to some extent the complexity of the present pattern of overlapping levies and is recommended. The license itself is useful for administrative purposes and should be retained.

11. GASOLINE AND MOTOR-VEHICLE-USE TAXES

For the motor-vehicle tax field the coordination device here recommended is separation of sources, the Federal Government to withdraw from the field as much and as soon as its financial exigencies will permit. While a plausible case can be made for Federal taxation of motor fuel to finance Federal highway aid, the connection between the tax and the aid is a loose one and might well be severed to eliminate the overlap at this point and to allow the States the exclusive occupation of this field. The basis of this recommendation is that this tax field forms a lucrative and badly needed source of revenue for the States, and one which they are exploiting or might exploit adequately and satisfactorily. Federal collection and State sharing, and other coordination devices, would create more problems than they would solve. The motor-vehicle taxes at the State level are devised mainly as benefit taxes, and the diversities in rates and other special features which occur are mainly adaptations to special needs and other conditions in each State. The Federal automobile-use tax offered an opportunity for Federal-State administrative cooperation, but the impediments, suddenly confronted, proved too difficult. This is an excellent example of the necessity of developing the implementation and close working relationships which are the condition precedent to joint administration. Even with present limitations, however, there appear to be no insuperable or even impressive difficulties in a program which would require a Federal automobile-use tax receipt as a condition for the issuance of a State license. The issue might also be disposed of by enforcing a requirement that evidence of payment of the Federal tax to be offered as a condition for rationing privileges.

Looking to the future, it is suggested that Federal and State separation of sources in the motor-fuel tax field might take the form of exclusive Federal taxation of fuel used in aviation, and exclusive State taxation of other motor fuel. This recommendation presupposes that aviation gasoline will remain a product separate from motor-vehicle gasoline. If the two products were to become interchangeable, separation of sources might not be administratively practicable. Two-thirds of the States now exempt aviation fuel from State taxation, and the remainder either have special aviation-tax provisions or do not receive much revenue from this source. Potentially, however, the field is promising. It is appropriate for the Federal Government, since aviation is essentially an interstate enterprise and the licensing of airplanes and the regulation of air travel are already national. If the Federal Government so desired, it might use the yield of the aviation fuel tax to finance the construction and maintenance of free public airports, the laying out and maintenance of beacon systems, the provision of weather information, and the regulation of pilot licensing.

A troublesome aspect of the motor-vehicle tax system is its application to trucks, particularly the excessive license fees required of trucks by States outside of the State of the owner's domicile. While much can be said for Federal action to eliminate what in some cases amounts to a trade barrier, it is believed that State reciprocity and persuasive mediation by a Federal-State Fiscal Authority would constitute the best means of attacking the problem.

12. RETAIL SALES TAXES

The retail sales tax is not an overlapping tax at present but if it becomes such, by virtue of Federal entrance into the field, the coordination device to be highly recommended is administrative collaboration leading toward joint administration. Even with some diversities in State laws, complete duplication of administration in this field would be wasteful and otherwise undesirable. The Federal Government, especially in wartime, should draw upon the experience and facilities developed by the States.

Facilities of State and municipal sales tax administrators could be utilized to obtain a list of vendors of tangible personal property. Mutual exchange of information in such matters as the opening of new businesses, discontinuance of old businesses, and changes in ownership would prove helpful in reducing tax loss. The development of a joint auditing program, or the exchange of Federal and State audits, would operate to the benefit of both Federal and State authorities in that each would realize more extensive field audit control over taxpayers without corresponding increases in audit costs. The pooling of scarce sorting and tabulating equipment wherever feasible would also reduce costs. If practicable, the development of joint return forms would reduce administrative and compliance costs.

Going further, it would seem desirable that an opportunity be left open for experimentation, either in State collection of the Federal tax, Federal collection of the State tax, or even the collection of both taxes by a joint administrative agency (as recommended in Australia).

Other coordination devices, such as Federal collection and State sharing, are objectionable because they would in effect universalize, by Federal compulsion, reliance by the States upon a regressive tax source. The use of the sales tax by the States is none too satisfactory on the administrative side; difficulties arising from the interstate nature of much trade have been only partially eliminated by the use tax and liberal court interpretatious of the States' power to tax. But the remaining difficulties are by no means intolerable.

13. BUSINESS TAXES

Business taxes probably offer the most difficult problem of coordination to be found in the overlapping tax system. However, the need for correlation of business taxes is very great. The confusion in this sector of the tax system is impressive and the possibilities of repressive effects upon the economy are considerable. The Federal system of business taxation is itself uncrystallized and is at present ordered considerably by the exigencies of war finance. The absence of a Federal policy renders the development of plans for Federal-State coordination doubly difficult. Unfortunately, no generally accepted objectives of sound business taxation are available. The following are suggested in this report:

(1) If indeed there is any valid reason for taxing business as such at all, it seems that the relative place of business taxation in our tax system is too large and that this form of taxation should be "de-emphasized."

(2) An important present justification for business taxes is that considerable income is short-circuited within corporations and reaches

the stockholder only after considerable delay, if at all. New techniques should be devised for subjecting this short-circuited income to the same scale of personal income taxation as is applied to distributed income.

(3) The present combination of heavy taxes on corporate net income and additional taxes on dividends as part of the base of the stockholder's personal income tax places an unwarranted differential strain on equity financing. Either the deduction of bond interest should be disallowed (with appropriate limitations) in the computation of the corporate tax base or, better still, a partial credit should be given the corporation for dividends paid out.

(4) There is considerable support for the view that corporations should pay some taxes, in addition to property taxes, for the benefits received from governments. This would mean the utilization of bases which would reach businesses with or without net income. Indications regarding the proper type of corporate taxation may perhaps be derived from interpretations of the relationship between the Government and the corporate entity. On one hand, the Government may be considered a partner in the corporate enterprise, to share in the profits through a tax on net income. On the other, it may be considered a cost factor of production, to be compensated through a cost tax (on gross income, value added, or the like) regardless of the profitability of the business. However, it seems probable that applying taxes to net income is likely to be less repressive than making taxes a universal business cost. Moreover, the incidence of taxes on business, based on factors other than net income, is uncertain and confused. A retail sales tax, aimed at the consumer and close to him in its application, is more dependable in its effects. A tax system consisting of a personal and corporate income tax and a retail sales tax would be preferable to one consisting of the first two and business taxes based upon gross income, value added, or capital stock. Accordingly, it is recommended that no attempt be made by the Federal Government to extend its business tax system to corporations operating at a loss, and that the tendency of States and cities to levy such taxes be discouraged.

(5) Whether partnerships and individual proprietorships should be included in the scope of a business tax system is a difficult question, especially since there is no clearly defined province for the term "business" and it can easily be stretched to include all productive activity—even that of wage earners. Probably only more confusion would result from an attempt to tax individual businesses and occupations generally.

(6) The excess-profits tax, whether or not it is to be used beyond emergency periods, requires Federal perspective for its successful application and need not concern us further here.

(7) Whether or not special treatment is required for the taxation of insurance companies, banks, and public utilities is another troublesome problem. Probably an effort should be made to integrate so far as possible all these special classifications under a general business tax. An exception in the case of insurance companies is probably warranted so far as the States are concerned, but even here the Federal Government should continue its experimentation with the difficult task of integrating insurance and net income taxation.

A good case could be made for the exclusive taxation of business by the Federal Government, with the States sharing in the revenues. Probably our complicated, highly diverse, highly arbitrary system of business taxation, with its high cost of compliance, capricious and extraterritorial incidence, and uncertain economic effects; with its double- and triple-deck application; and its penalties through unjust apportionment upon cosmopolitan business, should be replaced by a new streamlined uniform centralized system.

This might be accomplished by distribution of a portion of the federally collected tax, on condition that States and municipalities retire from the use of capital-stock taxes, gross-income taxes, corporate net-income taxes, insurance taxes, and other taxes on business. This program would involve heavy complications, including the separation of business taxes from property taxes, Federal apportionment, and the adaptation of the program to the needs of the States. Against these must be balanced compliance costs resulting from diversities, injustices, and losses of revenue owing to jurisdictional confusion, and the repressiveness of State forms of taxation. A quantitative appraisal of what these causes for action add up to is not possible without research that cannot be attempted in an emergency period like the present. The results might support a recommendation for complete federalization of business taxes by application of a Federal sharing program. Were this recommendation made for the present it would have academic significance only, for public opinion is not prepared for such drastic action. In any event, pending a quantitative appraisal concerning the matters above discussed, the practical coordination program that can now be recommended must be confined to the following:

1. Better integration of the personal and corporate income tax at the Federal level as explained above.
2. State use of a system similar to the Federal, with resulting possibilities of joint administration; mitigation of multiple taxation, and State supplementation.
3. Research and education in this whole field. Particularly important is a quantitative appraisal of the impediments to business resulting from diverse State business taxation practices.
4. Federal incorporation of corporations engaged in interstate business.

This offers one solution for the problem of interstate competition for the corporate tax base. It would not prevent the States from taxing some appropriate share of the business when the corporation operates within their borders, but it would prevent them from taxing the entire capital stock of a corporation even when its activities are almost exclusively in other States. Federal incorporation would hardly be justified merely to remedy tax inequalities, but the importance of this measure for the regulation of interstate business is generally conceded.

Consideration might be given to the proposition that in the interest of a better balanced Federal tax the use of alternative bases be inaugurated. Net income would remain the major basis for the tax but alternative levies would also be provided: one, a flat minimum tax to cover the cost of administration or to exact a small charge for the privilege of corporate existence; a second, based on either "value added" or capital stock, preferably the former, to exact a payment on the benefit theory from corporations showing no profit. The taxpayer would be liable for the highest of these alternative taxes; rates would be so adjusted that the average business would normally pay the net income tax as the highest of the three alternative levies. But even the unprofitable businesses would have some taxes to pay, and in times of depression the alternative levies might add stability to the revenues. However, for reasons already stated we are not prepared to recommend this program at this time.

14. STOCK TRANSFER TAXES

The stock transfer tax is unique among the overlapping taxes in the degree to which the State tax revenue is concentrated in one State, New York, and the degree to which the incidence of the tax falls on the nation outside of the taxing State. The New York Stock Exchange is peculiarly a national institution. According to informed opinion, well over half of the transactions on the exchange originate outside of New York. The case for coordination in this field rests mainly upon the contention that the Federal and State taxes are levied without much regard for each other, and that the combination is excessive. Proposals for coordination have been confined largely to the idea of applying a credit for State taxes against the Federal tax. But the credit would tend to stimulate State taxation of stock transfers, and might lead to many multiple taxation problems now largely dormant. Only five States other than New York attempt to tax stock transfers now, but others could assert a claim on the basis of the domicile of the parties to the transfer, or of the corporation whose stock is transferred. It may be doubted that the present load of combined stock transfer taxes is excessive, but if this be so the load could be considerably eased by eliminating some of the crudities in the present stock transfer tax laws. The stock transfer tax, because of its incidence, is best suited for national exploitation, and on this ground separation of sources, with the tax to be levied by the Federal Government, might be recommended. But New York has a strong proprietary interest in its stock transfer tax and is not likely to surrender it except under considerable pressure. The revenue from the tax is relatively much more important for New York State than for the Federal Government. Under the circumstances, the best recommendation appears to be that of forbearance, with most of the restraint to be exercised by New York State.

15. PAY-ROLL TAXES

Coordination problems as to pay-roll taxes center principally around efforts to reduce costs of administration and tax compliance. While compliance costs here as elsewhere have been left largely to guessing, the view prevails that they are very substantial. However, excessive reporting and other inconveniences result as much from the two Federal as from the overlap of the Federal and State taxes. Very little can be done in the way of coordination until the Federal unemployment compensation law is amended to cover employers of one or more, thus making the coverage similar to that under old-age and survivors insurance. Efforts to coordinate the two Federal taxes, and the coordination of State forms and procedures for unemployment compensation with Federal forms and procedures for old-age and survivors insurance would be expedited. Twelve States had already taken this step on their own initiative by 1941. It is true that if the State tax were eliminated, the integration of Federal taxes would be made easier and administrative and compliance costs might be considerably reduced. This, however, would involve complete centralization of the unemployment compensation system, and many implications broader than the issue relating to taxes.

There is a substantial case for the transfer of pay-roll tax administration from the Bureau of Internal Revenue to the Social Security Board. This would be in the interest of better coordination at the Federal level. The coordination of benefit and tax raising functions has already been adopted by the States, and is the method used by practically all foreign countries. Issues of benefit rights and tax liability should be settled simultaneously by one agency, and social-security taxes cannot be thought of in the cost-as-against-the-yield sense more appropriate to ordinary tax administration. This change is not now recommended, because the prospective inauguration of collection-at-the-source in income taxation may change the balance of advantages in favor of collection of income and pay-roll taxes by the same agency as at present. The matter merits reconsideration later.

The crediting device was incorporated into the unemployment compensation system partly to counteract interstate competition. However, the threat of interstate competition has reappeared in the operation of merit rating systems under which, in States that apply them, concerns with good employment records are granted a pay-roll tax advantage. If all States adopted similar merit rating schemes, this might be unobjectionable. Advantages would represent only the incentive which the merit rating system is designed to supply. Where only part of the States adopt merit rating an element of unfair competition appears, and if merit rating is used (as alleged) as a pretext for general undermining of standards, the competition begins to involve States as well as firms. Imposition of Federal minimum standards, as to tax rates, benefits, or reserves, preferably the latter, might mitigate this problem. But it would go far toward undermining State responsibility and independence. Pending a further opportunity for States to demonstrate their competence in the field of unemployment compensation, no change is recommended except that the Social Security Board assume an educational role, privately and publicly informing States when reserves or benefits are thought to be substandard.

Many suggestions have been made for various changes in the present credit grant combination which constitutes the coordination scheme of unemployment compensation. Increasing the Federal credit from 90 to 100 percent is a possible innovation that merits attention. This would go far toward the elimination of the Federal tax and the administrative and compliance costs which attend it. The change would, of course, involve some loss of revenue for the Federal Government. The 100 percent grant for collection of State pay-roll taxes and the administration of State unemployment compensation systems has worked well in most respects (particularly in its salutary effect on State personnel standards) but it has sacrificed the safeguards against waste which attend State budgetary supervision. Some recasting of the program to give the States an equity in the administrative outlays, perhaps variable in degree, depending on the financial ability of the States, is worth further consideration.

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V. Tax Immunities

16. PAYMENTS IN LIEU OF TAXES

Federal payments in lièu of taxes on Federal properties located within the boundaries of local governments presents one of the more difficult and less satisfactorily handled problems in intergovernmental relations. The problem has been aggravated by the Federal acquisition of large tracts of land for reservations, cantonments, airfields, arsenals, transport facilities, ammunition depots, and other defense facilities. These acquisitions often create difficult local financial problems because they deplete the local tax base, and because in many instances Federal properties make it necessary for local governments to expand governmental services. The Federal Government has adopted the practice of making payments in lieu of taxes to local units. However, the practice has been opportunistic and unsystematized. The arrangements have varied with different Federal projects. Some public housing projects pay nothing to the municipality which provides them service; others make substantial payments. Local dissatisfaction with payments in lieu of taxes is very great, and the resulting irritation in Federal-local fiscal relations imperils worth-while Federal projects and encourages resistance to the Government's efforts to improve the tax system. Those opposing the discontinuance of tax exemption for the interest on State and local government bonds have made a major point of the quantity of tax-exempt Federal property. They maintain that the cost of local functions and debt service is increased at the same time that Federal property purchases reduce the local tax base.

A legal aspect of this problem, often overlooked, is that many Federal properties involve Federal jurisdiction and that such jurisdiction may relieve State and local governments from any obligation to provide services.

More important by far than any single set of rules and principles for guidance in determining payments in lieu is the development of some machinery whereby such rules can be established, revised, and used effectively. In other words, what is needed is a clearinghouse for payments-in-lieu proposals. An agency of the sort suggested could also play a useful role in hearing complaints—particularly local complaints—concerning payments in lieu of taxes. A Federal-State Fiscal Authority could function most effectively in these two roles.

A better correlation of programs for payments in lieu of taxes might also be promoted were Congress to establish a special joint committee (perhaps temporary) to consider the large volume of new legislative proposals which fall in this field.

It would be presumptuous for any person or group of persons with limited experience to attempt to state a set of principles applicable to all the myriad situations which call for judgments as to payments in lieu. Nevertheless, a few generalizations can be offered.

(1) It is more desirable to develop a consistent and intelligible policy in this field than to insure the most perfect balance of interests in specific situations.

(2) Some recognition should be given to the benefit bestowed on a community by the location of a Federal function. The location of all functions, private and public, is usually beneficial, but it does not follow that the functions should be tax exempt. There may be

exceptions, however, where Federal programs assume functions which might otherwise have to be performed by State or local public agencies such as public works projects financed from general tax funds, or as special improvements financed by special assessments. Flood control and reclamation activities are examples.

(3) Property that has long been owned by the Government, and new properties of the same class should ordinarily be exempt with no compensation from Federal funds. The affairs of all concerned have long since been adjusted to the exemption status. No useful purpose would be served, for instance, by subjecting the United States post office property and general administrative buildings to local taxes. The extensive holdings of public domain have never been taxed and probably should also be placed in this category, although revenue-sharing devices of long standing are in operation and will probably have to be retained. Also where properties recently acquired, notably military areas, have caused sudden and serious local tax loss, payments covering actual loss should probably be provided although the properties are of the same order as those long owned and exempt.

(4) Where services are sold by Governmental agencies on a commercial basis and in competition with similar private activities, as in the power projects, the commercial element of the property involved should ordinarily be valued by the Federal Government with primary consideration to a capitalization of the income. The alternative of payment on gross income may be preferable in some instances, particularly where comparable private taxes are based on gross income.

The case of low-rent housing differs in that a subsidy element is involved. Payments in lieu of taxes should be made on a contractual basis, taking into account the ability to pay of the families rehoused as reflected by the rentals charged in the project.

(5) Other Federal property that is ordinarily utilized by or designed for sale to private individuals, such as farm and resettlement properties or additional Indian lands, should pay the equivalent of levies on similar privately owned property. For this and other federally owned property on which in-lieu payments are made valuation should remain subject to Federal control.

(6) Property acquired for conservation purposes (such as submarginal and cut-over forest lands) might well pay a low, flat, average rate on value as of the time of acquisition. This would constitute a minimum guaranty, pending larger local receipts from a distribution of revenue when the property becomes revenue producing. The flat rate would represent a rough adjustment to average effective tax rates on this type of property. The percentage of revenue shared would resemble a severance tax. This plan is considered feasible, not only for ease of administration in the case of large holdings of low value, but also as an approximation to what is considered to be good property tax practice on depleted lands.

(7) Although in the main full local services should be supplied the Federal property and its residents, there are cases in which the Federal agency is obliged to supply directly public services and facilities customarily financed out of local property tax funds. The Federal agency may even make the facilities available to local residents. In these cases there is room for adjustment of the payment to local units, particularly when the amount otherwise payable is the full equivalent of local taxes on land and improvements.

The above list represents an oversimplification of the problem, and is submitted in the hope of focusing attention on fundamental issues.

It is recommended that the Federal Government provide the facilities for a continuing inventory of public property. This is desirable not only for its own sake but also to facilitate the development of balance sheet accounting for the Government.

Unless something is done to improve Federal-local relations concerning payments in lieu of taxes, valuable programs such as those in the field of housing may be imperiled. It is hoped that steady improvement might be made under a program such as that outlined above.

17. STATE AND LOCAL TAXATION OF GOVERNMENT CONTRACTS

The controversy involved in the taxability of Government contracts under State and local sales and use taxes has been aggravated by the war program. The United States Supreme Court recently held that in the absence of congressional declaration to the contrary, purchases by cost-plus-fixed-fee contractors engaged on Government contracts are subject to State and local sales taxes.

Several factors suggest the desirability of permitting the States to tax these purchases. States are entitled to some compensation for services rendered to defense industries. Taxes under such circumstances are, to repeat the words of the Court, "but a normal incident of the organization within the same territory of two independent taxing sovereignties." A distinction between sales taxes and other taxes applicable to Government contractors appears unwarranted. Federal consent to State taxation of defense contracts is a comparatively desirable form of Federal aid to States. Moreover, a liberal Federal policy in this respect would strengthen the Government's case against the continuation of tax-exempt securities.

If the Government were to assume ownership of the railroads few would contend that the States should go uncompensated for the loss of such a lucrative tax base. It seems doubtful if the preemption of the business of the automobile industry for war purposes differs in principle.

It is argued that permitting the States to tax purchases by Government contractors creates great embarrassment in Federal administration and a large additional load for the Federal budget. Tax compliance, whether by public or private parties, is always troublesome but not less necessary on that account. Considering the facts that the total yield of State sales taxes in 1941 was only $671,000,000 and of the gasoline tax $800,000,000, the cost of these payments is not likely to loom very large against the enormous sums expended on the war effort. Cost determinations are difficult but at the current rate of expenditure on contracts, the annual cost on a very generous estimate does not exceed $162,000,000. It is probably substantially less.

It is concluded that at the very least Congress should concede the taxability of independent and cost-plus-fixed-fee contractors. Going further, it might allow taxes on all defense purchases. It is perhaps too much to expect that it will go the whole way, attempting to eliminate all immunity on all Government purchases. But even this would, in our opinion, be well within the bounds of sound public policy.

18. TAX-EXEMPT SECURITIES

Whatever may be concluded as to the merits of the argument concerning tax exemption of government bonds, there can be no doubt that the effort to eliminate this feature of our tax laws has met with constant, general, and bitter opposition from many State and municipal officials. It is the proposal to include the interest on State and local bonds in the base of the Federal income tax which is most in conflict.

That States and municipalities would find this a fatal impediment to credit operations or other State and municipal fiscal interests seems quite unlikely. These units managed very well without this advantage before the income tax was developed. State and municipal bonds commanded an excellent market and a considerable advantage over other bonds in this earlier period. Moreover, governmental units manage quite successfully to obtain credit in Australia, Canada, and many other countries without immunities.

The balance of gain and loss from the intergovernmental exchange of immunities is very obscure and depends upon many of the notorious vagaries and uncertainties in calculating the effects of tax exemption. While the advantage to States and municipalities in reduced interest costs as a result of tax immunities for their bonds is not subject to clear demonstration and has been categorically denied to exist by some critics, it has been quite generally conceded that the exemption might cause a difference in interest rates ranging up to one-half of 1 percent. During recent years, State and local bond issues have amounted to $1,000,000,000 per year and if the volume should continue, extra interest payments might amount to $5,000,000 in the first year and eventually to as much perhaps as $100,000,000 per year. Against this loss, of course, would have to be offset any gains which the States might realize if the States and their subdivisions were allowed to tax Federal bonds.

The argument that the elimination of tax exemption would involve a dangerous shift of power to the Federal Government is rebutted by the proposition that no authority is sought to levy a discriminatory tax. But it is said that if Congress has the power to tax State and local securities it could tax some and exempt others. Of course, Congress already has the power to subsidize some local functions and not others through its subvention system. But if a shift of power is at issue, the Supreme Court could take care of the matter by declaring the power to tax governmental instrumentalities (without discrimination) to be reciprocal. It is also alleged that if the door is opened to tax the interest on State and local securities, this will make municipalities liable to taxation on their public enterprises. But this does not seem to follow. There is a wide difference between taxation of private individuals who own government securities and the taxation of government enterprises where no private parties are involved. Centralization of power is not part of the purpose of those who seek to eliminate exemptions from the income tax.

It is quite unfortunate that the two issues involved in the elimination of tax-exempt securities have become so badly confused. The proponents of exemption elimination are not "out to deprive the municipalities of such limited fiscal advantages as the latter now possess." Nor do most State and local officials take any pleasure in serving as a "front" to protect the patently unfair privileges of rich taxpayers. It is to be hoped that these two groups can get together on some kind of a program which will meet the objectives of both.

Many suggestions toward this end have been made. One proposal worth serious consideration is that the Federal Government might establish a Federal bank for States and municipalities. The lending operations of the Reconstruction Finance Corporation in recent years have been of substantial assistance to debtor States and municipalities, and such arrangements might be continued on a permanent basis. Another proposal worth considering is a crediting arrangement whereby the differential advantage in tax exemption of large income recipients would be wiped out. More promising politically, perhaps, is the suggestion that the Federal Government grant a direct subsidy to units which borrow in the future. The equivalent of one-half of 1 percent on the outstanding principal of new bond issues could be paid to the issuing units annually. This would have the effect of eliminating the inequities in the income tax created by tax exemption, and would convert a hidden and indirect subsidy into an open and direct one. If a compromise is necessary to secure action and promote better governmental relations, and such seems to be the case, this solution is recommended.

VI. Expenditures, Functions, and Aids

19. REALLOCATION OF FUNCTIONS AND POWERS

Had this report been written in 1930 the inadequacy and inflexibility of the constitutional and statutory division of functions and powers would have required more attention. At that time it appeared that the Federal Government was quite inadequately endowed with power over interstate corporations and to cope with the business cycle, powers which it alone had the perspective and size to exercise effectively. Since 1930, revolutionary changes have taken place with regard to Federal functions and powers. The legal boundaries of "interstate commerce" have been and are still being broadened; a new element of flexibility in the interpretation of the Federal Constitution has appeared; and precedents for the use of the Government as an instrument for dealing with depressions and unemployment have been established.

Nevertheless it would be rash to leave the impression that the present division of functional responsibility is in any sense crystallized or beyond criticism. The division is and probably should remain in a state of flux and constant adaptation to changes in conditions. In some instances increased Federal participation is warranted, and whether this should be direct or through the grant-in-aid mechanism is to be weighed in each case in terms of the advantages and disadvantages. To choose a few examples, the Federal Government almost certainly should provide a larger portion of the cost of education. Most of this increased support should probably take the form of a revised and more generous grant-in-aid system. But direct provision of scholarships to insure the full development of talents (on the order of the National Youth Administration allowances) may also have a place in the program. The Federal Government should probably extend its participation in outlays for direct relief. The present program, under which Federal support is confined to a limited number of work relief projects, is properly criticized on the ground that it tends to distort the welfare budget of the municipalities. Whether work relief should take the form of grants or direct participation is also a moot point, although the evidence seems to warrant no change from the present practice. Greater Federal outlays for public health seem to be overdue; however, there is conflict here between the proponents of health insurance, a direct Federal health program, and grants-in-aid. Probably grants-in-aid are preferable. Much the same problem arises in the case of nutrition, in which some participation has occurred through a direct Federal program (food stamps) approaching the problem from the supply side.

At the State and local levels, division of financial and managerial responsibility for schools, highways, and welfare is also in flux with some trend toward centralization, usually quite justified. Unfortunately there is a great scarcity of evidence concerning the relative efficiencies of different levels in the provision of services, a scarcity which suggests another field for pioneer research.

Controversy continues over the State sponsorship of the unemployment compensation system. Here the Federal Government has already asserted a very large measure of control, but the existing arrangement is criticized because of the limited scope of State programs. Unemployment is a national problem, and important advantages would result from changes which would put the Federal Government in a position to develop its social security system as a whole. On the other side, the interests in experimentation, participation, and adjustment of programs to local diversities may be cited. A law suited to New York may be badly adapted to Nebraska. Were the program to be inaugurated now, it is probable that a national system would have the preponderance of advantages. Since the States have been granted the leading role in the system, they should be given time and Federal assistance to demonstrate whether they can handle it successfully. Constant threats to federalize the function will only interfere with cordial Federal-State relations.

A very strong case can be made for a functional transfer requiring corporations doing an interstate business to secure a Federal charter. State incorporation has been plagued by the factor of interstate competition, resulting in the States with the weakest regulation getting most of the business. Data gathered by the Securities and Exchange Commission show that one State has issued charters to 29 percent of the corporations whose securities are listed with the Commission. This has tax as well as regulation aspects, for the State of incorporation has wide powers of extra-territorial taxation over the corporations it charters. Although the Securities and Exchange Commission has eliminated some of the grounds for a shift of the important incorporation function, and although a shift would cause considerable temporary business compliance cost, it is strongly recommended that as soon as the time is propitious, the Federal Government exercise its power to require corporations engaged in interstate commerce to secure a Federal charter. This implies, of course, that the conditions for the issuance of such charters will become a matter for the Federal Government to determine. This is another change that is long overdue.

20. FEDERAL GRANTS-IN-AID AND NATIONAL MINIMA

Regarding improvements in the aid system, it is observed first that while the scope of Federal aid developed very rapidly under the pressures of the recent depression, it is a mistake to call the existing practices a system. In many States, certain federally supported functions, such as old-age assistance and vocational education, have tended to get the lion's share of Federal, State, and local support at the expense of such locally supported functions as relief and general education. The system should be revised and brought into balance by an extension of its scope to include additional functions in which there is a clear national interest.

The aid system has developed no concept of a national minimum, that is, of functions of such strong national interest that the Federal Government should underwrite a minimum program and insure that the minimum standard be everywhere provided without an undue strain upon local resources. It seems that the strongest claimant for preferred position in this respect is elementary education, followed by aid to dependent children. Although agitation for differential aids for old-age assistance has been persistent, minimum standards here are not so clearly of national interest and all welfare outlays are more or less relative to the standards of wealth and income enjoyed by the general population in particular States. The conclusion is that differential aids should be inaugurated, and that they should start with elementary education. (This is discussed further in section 21 following.)

A desirable technique for aid distribution in the welfare field that would offer some advantage to the poorer States is that suggested in the Connally amendment, a graduated bracket system of distribution. For example, for the old-age program, the Federal Government might match on a 66⅔ percent basis up to the first $15 per month of aid given eligible recipients; 50 percent from $15 to $25; and 33⅓ percent from $25 to $40. By this sort of program in the welfare field, a strong Federal interest in bare minimum standards would be asserted, difficult measurements of fiscal capacity would be avoided, and intrastate equalization programs would be encouraged.

The control features of an aid program can be a very salutary influence and ought to receive more, rather than less, emphasis in the future. In addition to the traditional control devices—such as audit and inspection, and approval of State plans—educational aids should give attention to internal equalization, redistricting, and division of funds between whites and Negroes. All the aids should seek to improve standards of local government personnel. It is probable that more can be done in most cases with persuasion than coercion. Some outside criticism has a salutary effect on almost any government, and it is unfortunate that the Federal Government is not in a position to get the benefit of similar criticism from the States and municipalities.

The last word has by no means been written on the techniques of cost sharing applied in aid programs. Local interest in standards rather than expenditure, due concern for economy, reasonable but not excessive local effort—these are interests to be considered. If cost sharing is a necessary feature of equalization aids, it should be on the basis of an inverse ratio to ability, the latter gaged mainly by per capita income.

21. EXPENDITURES FOR EDUCATION

Education is a function which is traditionally and legally a responsibility of State and local government. In Canada this local responsibility is included as a constitutional guaranty. Although the Federal Government has had a finger in the educational situation for a long time, its present financial contribution runs to only 2 percent of the total cost, and local control is jealously guarded. The movement for more general and more generous Federal aid is not of recent origin, but it is becoming more and more insistent. The movement has been restrained thus far by the fear of Federal control, sectional disputes over the equalization principle, opposition of religious groups, and the condition of national finances.

A strong case for national interest and support has been built up by the proponents of Federal aid. With elaborate statistics, wide differences in per capita expenditure and educational opportunity among the States have been demonstrated. With few exceptions, the States lowest in financial ability are making the greatest relative effort to support public education. The poorer areas usually show the highest birth rates, and the underprivileged individuals frequently migrate in later life to areas of greater economic opportunity. The importance of public education in raising the level of consumption and production in subaverage areas and its possible effect in reducing future outlays for relief, health, welfare, and rehabilitation are also stressed. Citizenship interests in minimum standards for education are obvious. Consideration of local tax relief also enters the argument.

Any program of Federal aid for education confronts major issues of the degree and manner of central controls which should be included. Division between whites and Negroes can hardly be neglected. For 17 States and the District of Columbia, average expenditure per pupil in average daily attendance (1935–36) was $20 for Negroes and $50 for whites. Fortunately these differentials are being gradually narrowed. Their continued existence raises serious questions as to the effectiveness of Federal financial aid alone in equalizing educational opportunity. Latitude for Federal-State consultation and advice on this subject should be provided.

Lack of proper equalization procedure in State-aid laws is another aspect of the educational situation with which a Federal-aid program must be concerned, particularly if it is to involve equalization features. States differ widely in the degrees of State support for education, and the assistance in many cases involves little equalization. Obsolete State-local administrative organization, including small school units, is also involved. Federal aid for school construction with a view to district reorganization might play an important role in the initial stages of Federal support for general education. While Federal control of school curriculum in the direction of uniformity is to be avoided, there is need of a general review of educational objectives, and closer integration of vocational training and guidance with other school programs. It would be a serious mistake merely to raise the level of school expenditure without tangible improvement in the quality and usefulness of the educational offering. Just how much coercion, as contrasted with persuasion, should be involved in Federal control is a debatable point, but it is suggested that the latter in most cases would prove more effective.

Much weight needs to be given to the view held by many people that education is a part of their way of life, and that national participation means regimentation and the loss of important minority rights and interests. Concessions can and should be made to this feeling, but considering also the overwhelming national interests in the maintenance of minimum standards of educational opportunity, the concessions should not extend to a veto of Federal aid for general education with equalization features. Nor should it block a control program necessary to secure the Federal objectives. It is not an acceptable feature of our way of life to keep large sections of the population in ignorance. Of all the functions of government which might be candidates for national minimum status general education has the strongest claim.

In the field of secondary and higher education a conspicuous fact is the amount of latent talent in the population which is never developed. Many of the most promising youths discontinue education long before the opportunities for profitable investment, both from the personal and social points of view, have been exhausted. Better exploitation of talent would help to increase the national income and to diminish differences in its distribution.

As to higher education, the program had best be confined to aid to individuals rather than institutions. This might take the form of federally supported scholarships of various sorts, including loan scholarships and work scholarships on the order of those offered by the National Youth Administration. Scholarship loans to be repaid through the return of a percentage of the beneficiary's income (like a special income tax) over a certain period of time in the post-school period might also be considered. The amount granted on these conditions should be generous, but the selection should follow rigorous standards of fitness.

Wise Federal leadership with regard to educational development in the United States can make an impressive contribution to the economic, political, and cultural life of the country.

VII. Fiscal Policy

22. FISCAL POLICY AND PUBLIC INVESTMENT

Fiscal policy is a new phrase in the vocabulary of many people, but it has rapidly assumed a central place in governmental planning. Fiscal policy, concerned as it is with both public expenditure and taxation, has important implications for intergovernmental fiscal relations. Those implications require a brief examination of fiscal policy problems in this study.

The resurgence of private business and the release of deferred consumers' demand may leave no problem of unemployment after the war. Private business should be given every reasonable encouragement to provide abundant opportunity. But taking the generally accepted view that unemployment and idle plant capacity will become a problem, what should be contemplated as a program to meet such a contingency? Without attempting to outline the program in detail, one can make a few comments concerning the proper approaches.

The Government will and should underwrite the maintenance of a high level of economic opportunity and full use of resources and plant capacity in the United States. It should do so by public investments, selected and budgeted, as far as possible, so that they will pay for themselves during their period of usefulness. This means that the expenditures must be highly creative in the economic sense. Through direct collections from persons who use the services resulting from the investments and indirect collection through the tax system, each item of outlay should contemplate a closed circle of outgo and intake.

One of the big problems of the post-war era will be that of maintaining confidence within the private sector of the economy. This cannot be done with slogans such as "Let us spend ourselves into prosperity." Such slogans might create more unemployment than they alleviate. The psychology and accounting of sound public investment as a necessary and sensible program to cope with unemployment should be much more acceptable to private business.

Two views of the public debt have engaged attention during the last decade. One view is that large and mounting debt, unsupported by productive assets, is the sure road to bankruptcy. The other is that a deficit in itself is a beneficent influence creating employment and enhancing national income. It is hoped that these two views might be amalgamated in a future public investment program.

A "sound" public investment program contemplates a split budget with an operating portion regularly balanced, or at least balanced over the business cycle. The other portion—the capital budget—need never be balanced, but each item in the budget must itself be self-liquidating over a given period. A precedent for this procedure has been established in Sweden. The details are not easy to manage and require much political discipline—perhaps more than can be expected. The dual budget system is very easily abused. But alternatives to a program of the character recommended are not very attractive. A perpetually mounting dead-weight public debt and the issuance of non-interest-bearing obligations involve greater problems and a far greater departure from past traditions than the program here recommended. Of course, if no program at all is necessary, so much the better. But the situation is not so reassuring that we can afford not to be ready.

It is not difficult to find fields well adapted for public investment of the kind here proposed. Public health, regional development, public housing, and nutrition are familiar examples. There will be vested interests that would prefer to see public money invested in lines that are strictly "noncompetitive." These vested interests must be either dissuaded or pushed aside. It is partly to retain a large part of our traditional private economy that plans like the above are proposed, and they should have the united support of those who are interested in sane and orderly progress and in preserving traditional values.

The implementation of a public investment program involves many problems of intergovernmental relations. Reallocation of governmental functions, the use of governmental corporations, the application of Federal loans or grants might be chosen. The proper choice will depend upon the specific situation but it seems probable that a combination of loans and grants will be most appropriate—particularly if State and local government can be somewhat invigorated in the process. Apportionment should give major weight to the relative productiveness of alternative projects.

Local governments, like individuals, will have a considerable inventory of deferred construction needs after the war. But they may not have the financial capacity to meet these needs. They can to some extent insure this capacity by paying off debts and building reserves during the war. Possible Federal encouragement of this policy will be considered later.

23. FISCAL POLICY AND THE TAX SYSTEM

It is said that our over-all tax system is regressive for the low income groups and that this and insufficient progression for the high income groups makes it ill-adapted to the needs of an economy with chronic tendencies toward underconsumption and oversaving. Assuming this diagnosis of modern economic tendencies to be correct, what should be done about it in modifications of the tax system?

First, it may be asked, is it necessary to centralize the tax system in order to achieve a workable fiscal policy? The answer, it seems to us, is in the negative. The Federal tax system, according to the available data, is only a little less regressive for the low income groups than that of the States and municipalities.[1] If the Federal Government wishes to make the tax system less regressive, in the interest of more desirable economic effects, it might begin by working on its own segment of the system. Moreover, as previously explained, there are possibilities of developing independent local sources of revenue which are less regressive than those now employed. It will be necessary for the Federal Government to assume the major responsibility for emergency unemployment, but it is not necessary for it to encroach further upon local financial independence. The remedy for a regressive tax system is increased reliance upon progressive taxes, and the Federal Government has plenty of scope for the application of this remedy in its own tax system.

It is also alleged that the tax system is repressive—that it throws too many wet blankets on the "economic incentives." This contention to some degree contradicts the first, but perhaps something might be done to relieve repressiveness without adding to regressivity. Some relief for equity financing under the corporate income tax, the elimination of tax-exempt securities, a more orderly and logical and "deemphasized" system of business taxation—problems previously considered—should help to mitigate tax repressiveness.

VIII. COST OF ADMINISTRATION AND COMPLIANCE

24. COST OF ADMINISTRATION AND COMPLIANCE

The frictional costs of the tax system—cost of administration and tax compliance—deserve far more attention and study than they have hitherto received. A pioneer study of tax-compliance cost was undertaken and completed in 1934, but limitations in the scope and method of the study made the results somewhat inconclusive even for 1934. Since that date the social-security system has developed.

[1] The data represent conditions before the recent sweeping expansion in coverage in the Federal income tax. Some regressivity (due to Federal consumption taxes) continues at the bottom of the income scale, however, and the pre-war situation may be largely restored after the war.

Early in the development of the present study, the United States Department of Commerce agreed to sponsor a survey of tax-compliance costs but because of the war emergency the project had to be abandoned. The Commerce Department's proposed study contemplated a wide coverage of taxpayers and careful supervision of the cost-accounting procedure by which data could be obtained. These conditions are essential to insure reliability in the results. As soon as circumstances permit, this survey should be undertaken and its results carefully studied.

Increased attention to compliance costs in framing all tax legislation can be recommended. The simplified Federal income-tax return was a step in this direction. The recent removal of the requirement that Federal returns must be notarized is another.

Table 1 presents estimates concerning the cost of administration of Federal taxes for fiscal year 1941 prepared for this study by the Bureau of Internal Revenue. The Bureau does not maintain a cost-accounting system by which precise figures can be obtained. However, every effort was made to allocate properly the total cost of the Bureau among the various classes of collections.

The estimates follow:

Cost of collecting Federal taxes—Statement showing by class of tax the total internal revenue receipts, the total amount expended and obligated, and the cost of collecting each $100 of revenue

Class of tax	Internal revenue receipts, fiscal year 1941	Expended and obligated, fiscal year 1941	Cost of collecting $100 of taxes
1. Income and profits taxes:			
Individual	$1,418,382,771.51	$23,874,805.43	$1.68
Corporation	1,860,355,907.17	13,233,285.41	.71
Excess-profits	192,385,251.89	1,879,526.31	1.00
Total income and profits taxes	3,471,123,930.57	38,987,617.15	1.12
2. Employment taxes	925,856,460.38	6,329,216.49	.68
3. Capital-stock taxes	166,652,639.88	842,202.80	.51
4. Estate and gift taxes	407,057,747.52	2,099,622.40	.52
5. Alcoholic beverage taxes	820,056,178.33	13,640,954.52	1.66
6. Tobacco taxes	698,076,890.87	1,241,285.07	.18
7. Stamp taxes	39,056,966.09	245,184.90	.63
8. Manufacturers' and retailers' excise taxes	617,353,891.64	589,738.72	.10
9. Miscellaneous taxes	224,873,672.38	1,313,704.95	.58
Total, all taxes	7,370,108,377.66	65,289,527.00	[1].89

[1] Average.

Source: Memorandum from the Bureau of Internal Revenue, Jan. 5, 1942.

Available data on the cost of administration of State taxes are notoriously fragmentary, ill-defined, and unreliable, but such evidence as is available (much of it collected directly in this study) indicates that in few if any cases can the States collect taxes as economically as can the Federal Government; that the State taxes which tend to be expensive to collect are the tobacco tax, automobile license tax, and alcoholic-beverage taxes; that costs of administration even at the State level rarely amount to more than 3 percent of the tax yield. The picture presented is one in which margins of cost permit substantial savings, though hardly greater than in many other phases of government. However, administrative efficiency is not only a matter of ratios of costs to collections but also of the effectiveness of collections.

It is commonly observed among tax administrators that the first 90 percent of any tax is likely to be forthcoming to the public treasury with little outlay for administration. Moreover, tax administration is a policing job as well as a means of collecting revenue, and the justice of effective tax collection has value in terms of public morale and may even be an end in itself.

Administrative staffs, both Federal and State, should be on a merit system from top to bottom. The Federal Government has not always set the States a good example in this respect. The collectors of internal revenue and, until recently, their staffs have been outside the civil-service system. The case of the collectors, appointed by the President, involves problems of coordination and integration within the Bureau, as well as the usual considerations of personnel administration. Both the Federal Government and some of the States are making progress in this field.

If the fiscal independence of the States is to be maintained at even its present level, the proposition "Tax administration like any other function of government should be assigned on the basis of efficiency of performance" cannot be accepted without qualification. Moreover, collection is inevitably associated with expenditure or distribution and questions of efficiency in the latter processes must also be considered. But relative administrative efficiency should be an important consideration in weighing all coordination proposals. As previously stated, greater Federal-State collaboration can do much to reduce administrative costs and improve the effectiveness of performance. The transcript service now generously provided by the commissioner of internal revenue provides a method by which States get almost the full benefit of Federal income-tax audits. Kentucky, for instance, gets something like the equivalent of 20 auditors' work at a cost representing the salary of *one investigator for less than a month*. Much more of this kind of collaboration is possible and very desirable.

IX. Problems of Interstate Relations

25. MULTIPLE TAXATION

Multiple taxation in the form of two or more collateral jurisdictions imposing the same tax on the same tax base is a phenomenon of considerable and growing importance in our modern tax and economic systems. This field, too, deserves much more study. The problem is emphasized by recent court decisions which indicate that judicial limitations on multiple taxation are very substantially reduced. Multiple taxation is serious in the fields of personal and corporate income taxation, death taxes, railroad taxes, and capital stock taxes. While the States can and should do something through reciprocal legislation to reduce the amount of multiple taxation, the main impetus for improvement will probably have to come from the Federal Government. This means some interference with State and local fiscal independence but in the long run it will support such independence. It is a case of amputating a finger to preserve the arm. The Federal Government should seek to acquire the right of determining State jurisdiction to tax by means of favors and subsidies extended to the States. It may be questioned that Congress and administrators are wise enough to perform successfully a role which is now gradually being abandoned by the Supreme Court. But there is fair agreement concerning many matters of jurisdiction—a proper allocation formula for corporation income, for instance—and the States, with one or two exceptions, have no very high stake in jurisdictional vested interest. Some jurisdictional problems will have to be settled by compromise. Increasing multiple taxation acts as an unfortunate penalty upon cosmopolitan ownership and business, a sort of trade barrier, which it is the natural role of the Federal Government to prevent. It should not shirk its proper task in this matter.

26. OTHER PROBLEMS OF INTERSTATE RELATIONS

The States are much concerned with the geographic maldistribution of wealth and income of which substantial evidence is submitted in our main report. Variations are so great that the average income in one State is not even an acceptable relief standard in another. To illustrate, the average old-age pension in California in 1939 was $345. This exceeded the per capita income in 10 States in this year; it exceeded the per capita income of the poorest State by 70 percent. In general, the report shows that wealth and income tend to gravitate to large cities, particularly certain residential centers and those that specialize in financial functions. The States and cities engaged in the production of raw materials seem to fare badly in the distribution. Both on philanthropic grounds and because the distribution system may not reflect relative real contributions to the national product the facts of geographic maldistribution are of national concern. The Federal tax system and the Federal grants to the States might be used to mitigate geographic inequalities. Studies of the geographic incidence of the present Federal tax system and of the distribution of Federal aids leads to the conclusion that at the present time neither instrument functions very effectively toward this end and the aids in some instances are so distributed as to aggravate the maldistribution.

Recently many critics have become quite alarmed by the growth of trade barriers. State legislation, such as the special levies on oleomargarine, taxes and restrictions on liquor importation, and registration fees and regulations which apply to trucks and busses moving in interstate commerce are examples. Closely related are the problems growing out of special inducements offered to industry to locate in a certain city or State. The latter practice has been growing and has serious potentialities. While several minor suggestions have been made for dealing with these problems, they are best handled by interstate cooperation working through education and, in some instances, reciprocal legislation.

An ideal federal system in our modern era contemplates a group of semi-independent democracies held together by a constitution and a common tradition, and functioning smoothly through a statecraft that includes a large factor of cooperation. This cooperation must be partly in the field of interstate and partly in that of Federal-State relations. The true spirit of the Federal system is sustained by efficient *voluntary* relationships, which make the compulsions of the unitary state unnecessary. The Federal Government must be a partner in this cooperative interplay in more ways than one. It must be a direct partner, of course, in Federal-State cooperation, which must go hand in hand with interstate cooperation; it can assist the States in their efforts to work together; and it should assume the role of arbitrator in interstate conflicts (as in tax jurisdiction), where it is in a strategic position to balance opposing interests. (The double-domicile fiasco in the inheritance-tax field illustrates the wide-open gaps that now exist in the present operation of our Federal system.) The techniques and machinery of government which we have inherited from the past were adapted to an economy and a fiscal system in which cooperation could be minimized without critical damage. But cooperation is the lubricant that, under modern conditions, makes a federal system go. To develop enough of this lubricant to keep the machinery moving smoothly in the still more interdependent economic era that lies ahead is a major challenge.

X. Miscellaneous Problems

27. COMMUNITY PROPERTY

A unique phase of the problem of intergovernmental fiscal relations arises from the diversity of State laws concerning property ownership, which precludes the uniform application of the present nation-wide system of taxation. This is the problem of community property arising because of the laws of nine States under which husband and wife have joint ownership rights in the earnings of either, or from the property resulting from the earnings of either, after their marriage. At death one-half of the community property becomes the separate property of the surviving spouse without transfer and escapes the State death taxes and, until this loophole was closed by the 1942 Revenue Act, also escaped the Federal estate tax. In the case of the income tax each spouse may report half of the income from community property or activity for both State and Federal income tax purposes. This results in deplorable discrimination against the taxpayers of non-community-property States.[2] At least one of the nine States has deliberately amended its statutes in an attempt to give its citizens the advantage of this discrimination, but the Bureau of Internal Revenue has refused to recognize the amendment for Federal income tax purposes.

The income-tax discrimination could be removed by amendment of the Federal law to require joint returns. This result might also be accomplished by requiring all members of the family to sum their income, divide by the number of members, compute the tax, and multiply by the number of members. Territorial discrimination in the income tax law could be largely eliminated by providing that State community-property modifications of the common law shall not apply in the operation of Federal taxes. While it is not entirely certain, the probabilities are that Congress has the power to do this. It is recommended, accordingly, that Congress enact further legislation which would disregard these major differences in State property-ownership laws for purposes of Federal taxation and thus seek to establish the uniform application of its tax system.

[2] This discrimination is increased by the provisions of the Victory tax which grants a fixed exemption of $624 to each income recipient. Since all married couples in community-property States automatically share their income, they in effect receive a $1,248 exemption while most married couples in other States receive only 624.

28. IMPACT OF THE WAR ON STATE AND LOCAL FINANCING

The finances of State governments have thus far improved considerably as a result of high economic opportunity incident to the defense and war programs. The fiscal affairs of local governments also appear to be improving, but the situation is spotty and some cities have been adversely affected. None of the State and local governments has as yet experienced the full effect of Federal war financing and rationing upon its revenues. The possible effects of inflation and post-war readjustments are also important.

The effect of the war upon automobile traffic is certain to involve a very important loss of revenue from motor-vehicle taxes (particularly gasoline taxes) to State and local governments. While the loss may not be great in 1942 (even in this year it will be substantial in the rationed States), an estimate of a 35-percent reduction for 1943 is probably conservative.[3] Motor-vehicle taxes are the most important single source of revenue for States, and of considerable importance for local governments. On the other hand, highway expenditures are being and (except where such expenditure is for servicing debt) can be further curtailed. States diverting motor taxes to general governmental expenditures (15 percent diverted) cannot thus escape the impact.

Proposals for Federal reimbursement of State motor-fuel tax losses are considered premature. Improvements in other revenues, reduction in highway expenditures, rate increases in some States, and diversification of tax systems in others hold promise of offsetting much of the adverse effect. Impairment of debt service on highway bonds is not considered imminent, although highway aid to local governments will undoubtedly be curtailed.

Much of the financial responsibility for war-created activities must of necessity fall to the Federal Government because of the extensive interstate migrations of population and the concentration of war activities in some areas as the result of Federal decisions, and because adequate local public facilities and services are essential to the effective prosecution of the war. Congress has recognized a large measure of Federal responsibility by making several appropriations for war public works to be apportioned among local units to meet these needs.

The Federal Government's effort to prevent inflation is of vital importance to State and local governments. Experience during the last war indicated that an inflation can seriously disturb the equilibrium of State and local finances. Today the tax resources of these governments are more fully utilized than in 1917, and there is less scope for tax increases, especially in the field of property taxation. A severe inflation at the present time might render it extremely difficult to sustain State and local governmental services.

As a result of improved economic and fiscal conditions, some State and local governments are accumulating surplus revenues. It is probable that these surpluses will be increasingly required as a cushion for revenue declines and to finance emergency State and local expenditures. Further disposition of these surpluses has an important

[3] Written in the summer of 1942.

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bearing on the Government's effort to prevent an inflationary price rise. These efforts would be facilitated if State and local governments used these surpluses to reduce indebtedness or to build up reserves. The latter might be used to purchase United States War bonds. The development of a nonnegotiable bond subject to ready liquidation and otherwise adapted to the needs of State and local reserve funds would stimulate the use of such funds and their investment in Federal securities.[4] Conversely, if improved State and local financial conditions resulted either in tax reduction or expenditure increases, the Federal Government's anti-inflation program would be handicapped. State governments can facilitate the war effort also by providing assistance to war-affected cities, which are required to provide essential governmental services to war industries and their workers. Unreasonable requests for Federal aid should be avoided; States and municipalities as well as the Federal Government should show an interest in local independence. The States' position with regard to their own claim to exclusive use of motor vehicle taxes will be stronger if request for Federal assistance on account of revenue losses involved in gasoline rationing is delayed until genuine need is evident.

If all local governments were to cut taxes simultaneously, and the Federal Government were to increase its taxes by the same amount because of the local tax reduction, inflation would be largely unaffected and the revenue would accrue to the jurisdiction with the greatest current need. This would also enable the Federal Government to keep its debt at a minimum. The weakness in this solution is that not all the States are likely to act simultaneously, nor is Congress likely to take their action into account. Consequently, the less States disturb their tax systems, the better for the counter-inflation program.

States and municipalities can realize three objectives by surplus financing. This procedure not only will facilitate the anti-inflation program in which these governments have a direct interest; it will also build a reserve to cope with post-war contingencies, including deflation. In the third place the reserve might be useful in the event that Federal tax and control programs lead to a drying up of present revenue sources. The second objective needs further implementation in the development of plans (including blueprints) for post-war public works. Moreover, surplus financing is a new experience for many States and cities and needs legislation to safeguard reserve funds against misapplication. This is no simple problem. Terms of State and municipal officials are often so short that surplus financing is reasonably feared as a possible boon to political rivals of those in power. On the other hand funds must not be so tied that they could not be used in a genuine emergency. Several States and cities have passed legislation implementing a surplus financing program successfully. This experience might well be studied and copied. In addition, if local interest and available surpluses are sufficient to warrant, the Federal Government might implement the program quite successfully by offering the States and municipalities a nonnegotiable bond, redeemable after the emergency or upon a showing of a war-created need. The program might provide that if the bonds were retained and the funds used for approved post-war public works, the Federal Government would match the saving.

[4] This was written before the announcement of the recent security issues in the Victory-fund program which goes considerable distance in meeting the needs of the States.

Probably the simplest and most practicable solution of the surplus problem is the use of available funds to reduce indebtedness. In case of noncallable serial bonds an effort can be made to induce existing owners to tender their holdings. Very often, too, it is possible to reduce the lag in State and local financing and thus eliminate short-term borrowing. New indebtedness can be avoided by financing current improvements out of current revenue.

29. GOVERNMENTAL REPORTING

In this day of interdependence and planning there is a strong public interest in adequate information concerning the finances of Federal, State, and local governments. Governmental reporting is badly neglected in many parts of the country. Complete reporting and acceptable accounting practices are the exception rather than the rule, and such reports as are gathered are often not strictly comparable. A cooperative attack on the problem, initiated by the Census Bureau and with the participation of State officials, has begun. Further promotion in this direction is definitely in order. The Federal Government could well afford an appropriation to enable the Census Bureau to assume half of the cost of installing approved accounting and reporting systems in the States. Such expenditure might be a good investment from the Federal viewpoint; it would save the Government considerable sums required because of the necessity of going directly to subdivisions for information. A precedent for Federal expenditure of this sort can be found in the outlays to facilitate State and municipal reporting of vital statistics.

The Federal Government leaves important gaps in its own reporting and collecting of governmental financial data. For instance, it does not regularly compile data on the total public revenues and expenditures. Surely in this day of important governmental operation authoritative public information of this kind should be an annual product.

A Federal-State Fiscal Authority could play a vital role in improving our knowledge of intergovernmental relations. It could stimulate research concerning State and local government by State and municipal universities. It could maintain a library and information service in the field of intergovernmental affairs. This might help to counteract the growing idea that only what happens in Washington has any importance.

XI. Summary of Recommendations in Terms of an Action Program for Each Level of Government

I. FEDERAL GOVERNMENT

A. For immediate action.

1. Negotiate with State representatives and pass legislation to create a Federal-State Fiscal Authority.
2. Amend the income tax law to make State income taxes deductible on an accrual basis even though other expenses are reported on a cash basis.
3. Revise, modernize, and broaden the death-tax credit.

4. Give the Federal estate tax a thorough overhauling, integrating death and gift taxes, substantially reducing exemptions and coordinating the Federal and State taxes.

5. Eliminate tax-exempt securities in a manner to secure States and municipalities against loss arising from the taxability of their securities.

6. Defeat discrimination resulting from State community-property laws by providing that they shall not apply in the operation of Federal tax laws.

7. Provide a clearing house and "board of appeals" (Federal-State Fiscal Authority) for more careful and consistent treatment of payments in lieu of property taxes on Federally owned property. Such payments should be generous, especially during the war.

8. Provide a special joint committee of Congress to consider legislative proposals for payments in lieu of taxes; provide facilities for maintaining a permanent inventory of Government property.

9. Allow State sales-tax application to contractors working on Government orders.

10. Modify and improve the coordination and efficiency in unemployment compensation by increasing the Federal credit from 90 to 100 percent and requiring the States to furnish part of the cost of administration.

11. Disallow sales taxes as a deduction in Federal income-tax practice; if the deduction is retained, make it general and not conditioned upon certain technicalities in the tax law.

12. Pay more heed to cost of compliance in framing tax laws.

13. Extend the civil-service coverage to include all personnel engaged in Federal tax administration.

14. Consider the provision of a suitable bond instrumentality for the investment of State and local surplus funds during the war. This might take the form of a nonnegotiable bond redeemable after the emergency or upon a showing of war-created need, and to be matched by the Federal Government if used for approved public works.[5]

15. Continue and enhance cooperative efforts to improve State and local accounting and reporting; provide annual compilation of cost of government and total taxes.

16. Expend more effort on Federal-State collaboration in the administration of overlapping taxes.

17. Repeal the automobile-use tax, or, if it is retained, require receipt as a condition for obtaining a State license.

18. Further promote better uniform governmental accounting and reporting.

19. Assume the responsibility of annual calculation and publication of the over-all cost of government and other fundamental fiscal data.

20. Cultivate an attitude which regards States and localities as partners in a joint enterprise.

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[5] Written before recent developments which cover, to some extent, the needs of the States.

B. For immediate or future action.

21. Develop in consultation with the States, standard rules for income- and death-tax jurisdiction; develop suitable rewards for State compliance with these rules and other suitable procedures so that the Federal Government may serve as an umpire in multiple taxation disputes.

22. Develop in consultation with the States rules of uniform income-tax procedure; promote the adoption of such rules looking toward single administration of a relatively uniform State and Federal income tax.

23. Adopt a Federal-collection-State-sharing program for the tobacco tax.

24. Enact legislation providing for Federal incorporation of corporations doing an interstate business.

25. Provide distribution of welfare grants to the States through a graduated bracket system as suggested in the Connally amendment.

C. For future action.

26. Abandon motor-vehicle taxes to the States reserving the right to tax motor fuel used in aviation.

27. Inaugurate a thorough study of the cost of tax compliance and the burden of multiple taxation on interstate companies; reserve action on centralization of business taxes until this evidence is available.

28. Use a public investment technique (if necessary) to cope with post-war deflation and unemployment; dual budget; creative public works (health, housing, nutrition, and regional development); full liquidation of outlays.

29. Reduce repressiveness of the tax system by deemphasizing business taxes and by equalizing burden upon equity-financed companies compared with those financed by means of indebtedness (through a partial credit to the corporation for dividends paid out).

30. Broaden Federal aid to include relief and elementary education.

31. Broaden the Social Security program to include uncovered groups under old-age insurance and unemployment compensation. This would not only provide more equitable coverage but would also make possible some simplification of pay-roll taxes.

32. Recognize a national minimum status for elementary education by provision of a differential (equalization) grant.

33. Provide controls which will insure improvement in the division of educational revenues, local districting, and the quality of the educational product, at the same time insuring against coercive interference with local autonomy and minority views concerning education.

34. Provide for Federal scholarships to insure the adequate development of talent through higher education.

35. In the interest of simplification, repeal Federal liquor license fees retaining licenses where needed for administration.

D. Contingent action.

36. If a Federal retail sales tax is enacted, provide legislative implementation and administrative action to insure the fullest cooperative use of State personnel and machinery.

II. STATE GOVERNMENTS

1. Negotiate with Federal representatives and collaborate in the development of a Federal-State Fiscal Authority.
2. Negotiate with Federal officials and Congress to inaugurate a program for the elimination of tax-exempt securities in such manner as not to embarrass States and municipalities fiscally.
3. Tighten property exemption provisions; relax ceiling and uniformity requirements as to local property tax levies; develop more adequate supervision of property-tax administration.
4. In collaboration with municipalities, refrain from demanding unreasonable wartime aid from the Federal Government, thus recognizing the importance of local independence.
5. Apply surplus revenues, where possible, to the elimination of debt and the development of a reserve against wartime loss of revenue and post-war need for public works.
6. When revenues will permit, allow Federal income taxes as a deduction in calculating State income taxes.
7. Redouble attack on trade barriers, multiple taxation, and special inducements for the location of industry; use of education, reciprocal agreements, and interstate compacts toward these ends; pass legislation allowing credit to new residents for automobile license taxes paid in the same year to other States.
8. Collaborate with the Federal Government looking toward Federal arbitration of jurisdictional disputes and joint determination and promotion of uniform practices in income and business taxation especially with regard to questions of jurisdiction.
9. Further collaborate with the Federal Government in the joint administration of overlapping taxes.
10. Adopt legislation on their own initiative that would make payment of Federal automobile use tax a condition for the receipt of a State license.
11. Mitigate the "rotten-borough" system by providing more adequate representation for cities in State legislatures.
12. Give more consideration to cities in the distribution of shared taxes, particularly motor-vehicle taxes.
13. Adopt enabling legislation that would permit cities to supplement the general property tax with a rental tax on occupiers.
14. Adopt enabling legislation that would facilitate surplus financing during wartime.
15. Adopt legislation requiring more adequate and more uniform governmental accounting and reporting.
16. Cultivate an attitude that regards all governments as partners in a joint enterprise.
17. Collaborate with the Federal Government on a broader and more generous program of Federal aids, accepting controls, but insisting that they be cooperatively applied rather than dictated.

III. MUNICIPAL GOVERNMENTS

1. Negotiate with Federal representatives and collaborate in the development of a Federal-State Fiscal Authority.
2. Negotiate with Federal officials and Congress to inaugurate a program for the elimination of tax-exempt securities that will not fiscally embarrass States and municipalities.
3. In collaboration with States, refrain from demanding unreasonable wartime aid from the Federal Government, thus recognizing the importance of local independence.
4. Apply surplus revenues, where possible, to the elimination of debt and the development of a reserve against wartime loss of revenue and post-war need for public works.
5. Broaden the property tax program by supplementing the property tax with a rental tax on occupiers.
6. Strictly interpret property tax exemptions.
7. Inaugurate a thoroughgoing study of possible new sources of independent local revenue.
8. Study successful procedures for safeguarding reserve funds, and enact legislation needed for this purpose.
9. Develop more metropolitan cooperation and the use of large metropolitan districts for financing functions of common interest.
10. Emphasize raw material producing districts' claim upon aids and shared taxes because their tax base does not represent their contribution to the national product.
11. Demand more equitable representation in State legislatures.
12. Demand more equitable distribution of shared revenues, particularly motor-vehicle taxes.
13. Provide for more adequate governmental accounting and reporting.
14. Cultivate an attitude which regards all governments as partners in a joint enterprise.
15. Prepare for collaboration with the Federal Government in a post-war public investment program.
16. Collaborate with the Federal Government on a broader and more generous program of Federal aids, accepting controls, but insisting that they be cooperatively applied rather than dictated.

PART 1

DEVELOPMENT OF THE COORDINATION PROBLEM

CHAPTER I

DEVELOPMENT OF THE COORDINATION PROBLEM

A. Introductory Statement

A student should enter the field of intergovernmental fiscal relations with modesty and even humility. It is a large field cutting well across four or five of the social sciences and including in its scope some of the major problems of about 165,000 American governments of all shapes, sizes, populations, and degrees of sovereignty. The literature in the field is impressively voluminous. It is a field in which students and committees, one after another, have spoken their piece, registered complaints, made recommendations and achieved no action. It is a field mined with explosives; beneath a placid surface lie some very deep emotions ready to burst into flame at the slightest provocation. If discretion alone were the determining factor, the student might well choose some other field to conquer.

But the field is apparently one which needs fresh cultivation. Many of our ablest statesmen and wisest scholars of different parties and viewpoints have so told us. One of them says that "regarding the importance and urgency of the problem there can be little difference of opinion." [1] According to another, waste and confusion in overlapping and uncoordinated taxes are "no credit to a great Nation like ours," [2] and must be eliminated. "I have often expressed my belief," declared President Roosevelt on January 8, 1941, in submitting his Budget message for 1942 to Congress, "that no really satisfactory tax reform can be achieved without readjusting the Federal-State-local fiscal relationship * * *."

But the agreement does not extend far, even here. Some think that a small amount of attention to details here and there would suffice; others, that a thorough overhauling of the system is required. For example, Fred R. Fairchild expresses the opinion that the seriousness of the problem has been exaggerated; that some attention to details, rather than a radical or revolutionary revamping of the tax system, is needed; that each grade of government should continue to support its functions upon its own revenue.[3] On the other hand, Clarence Heer has expressed doubt of the efficacy of piecemeal remedies directed at specific abuses.[4] Some would move in the direction of stronger central authority; others think that the Federal Government is now too large and powerful. Thus, Simeon E. Leland, writing in 1930, expressed the view that "the financial system of a nation should be highly, if not completely, integrated."[5] J. A. Maxwell speaks with praise of "the subsidence of provincialism in Canada."[6] On the

[1] From a confidential statement.
[2] Letter to the authors from Mark Graves.
[3] Letter to the authors.
[4] Clarence Heer, "Relations Between Federal, State, and Local Finances," American Economic Review, Supplement, vol. 26, No. 1, March 1936, pp. 179–181.
[5] S. E. Leland, "The Relations of Federal, State and Local Finance," Proceedings of the National Tax Association, 1930, p. 96.
[6] J. A. Maxwell, Federal Subsidies to the Provincial Governments of Canada, Harvard University Press, Cambridge, 1937, p. 254.

other hand, Harley L. Lutz is disturbed by the prospect that the States may be demoted to a provincial status and that a "coordinated" tax system may turn out to be "the kind of order the wolf would establish in the sheepfold."[7]

1. BROAD SCOPE OF INTERGOVERNMENTAL RELATIONS

Although not confined to federal systems, intergovernmental fiscal relations constitute mainly a corner of the much larger field of federalism. The latter includes much more than can be considered in this study. To be sure, the functional approach to the subject of fiscal relations cuts across a very wide part of the larger field. Some attention is given to these wider aspects in the treatment of the functional approach. But time and other resources did not permit any coverage of such questions as the following:

Are our monetary and foreign trade policies fair to all sections of the country? Has our regulation of transportation rates operated equitably in this respect? Would it be practical and desirable for the Federal Government and the States to develop a joint program for the recruitment and promotion of public personnel? Is removal of Federal protection of interstate commerce from certain subjects of restrictive State legislation a desirable means of intergovernmental cooperation? All these problems have a bearing on fiscal relationships.

Only the most limited kind of attention could be given to such questions as the following:

1. Should the Federal Government or the States take the exclusive or at least the leading role in unemployment compensation, old-age assistance, conservation, labor legislation, public-utility regulation, and public health? What would be a desirable State-local division of functions?
2. Should there be a reorganization of local government to create fewer units, better adapted to rural and urban needs?
3. What elements of inefficiency in State and local governmental organization tend to create a demand for centralization of control in the National Government? What elements of inefficiency in the Federal Government tend to create distrust of centralization?

These questions are selected at random among many ramifications of federalism. The problems in this field are so numerous and complex that they cannot be encompassed by one study. In recognition of this view, a committee of the Social Science Research Council is preparing an extensive outline of needed research on federalism and intergovernmental relations.

2. DEFINITIONS

The above questions illustrate the difficulty in defining a field designated as Federal-State-local fiscal relations. In the broadest interpretation, the field would include the following:

1. Coordination of Federal with State and local taxes.
2. Coordination of Federal with State and local fiscal systems (including expenditures and public debt).
3. Coordination and cooperation among States themselves in the operation of their fiscal systems.
4. Coordination of all intergovernmental operations.

[7] Letter to the authors. Further conflicting opinions on coordination are presented below.

5. Coordination of State-local fiscal relations.

While all these are treated in this study to some extent, principal emphasis is given to the first and, to a lesser degree, the second and third of these divisions of the field.

B. Origins of the Problem

1. NATURE OF THE FEDERAL SYSTEM

(a) *Origins of the system.*

The organization of many smaller communities into a larger whole usually takes one of two forms.[8] The first is a league of nations, an aggregate of communities, as such, bound together rather loosely for some common purpose like defense. The German Confederation from 1815 to 1866 and the first union of the colonial States under the Articles of Confederation were of this type. The second form is a unitary state in which the subcommunities are the creatures of the nation and the latter acts directly for its citizens in most respects. France, with its Departments, illustrates this second type, and we are familiar with it in the subdivisions of our American States. But the American Federal system is half-way between the two types described above. The National Government commands the obedience of the citizen and acts directly for him in a considerable number of respects. The States also have their own authority over the citizen, and they are by no means mere administrative units of the Federal Government, existing under the latter's sufferance. "A comprehension of this double organization," says James Bryce, "is the first and indispensable step to the comprehension of American institutions." [9]

At the time the Constitution was adopted, the sad failures under the Articles of Confederation, the weak state of the public finances, and the menace of foreign aggression worked in favor of a strong union. But the diversities and jealousies and the fear of centralized power existing in the Colonial States made even a compromise settlement dubious. Considerable concession had to be allowed to the centrifugal forces of the period. Even so, it is doubtful whether the Constitution would have carried by popular referendum, and its adoption by State conventions was a matter of great doubt and considerable delay. The Constitution was the product of prolonged effort by an unusually able assembly. Perhaps its most difficult problem was that of Federal-State relations. Years later, an English critic described the final product as well deserving "the veneration with which Americans have become accustomed to regard it." [10]

The Federal pattern accepted by the founding fathers called for a national government of designated powers, limited as to number and scope, but supreme as to degree. The States were required to yield some of their original powers and to share others with the new Government. The remaining powers not ruled out by the Federal Constitution or by State constitutions were reserved for the States. The municipalities have never been "sovereign"; [11] they are merely sub-

[8] James Bryce, The American Commonwealth, fourth edition, Macmillan, New York, 1921, vol. 1, pp. 15-18.

[9] Ibid., p. 18.

[10] Ibid., p. 278.

[11] Much discussion during American history has developed about the concept of State and Federal sovereignty. Insofar as the term denotes ultimate power it is the people who are sovereign and, as applied to the National Government, it is all the people of all of the States in whom ultimate authority rests. See Arthur N. Holcombe, State Government in the United States, Macmillan, New York, second edition, 1926, ch. 1.

divisions of the States and depend upon the latter for such power as they have.

The designated powers of the Federal Government were confined to matters thought to have national importance and were few in number; mainly, they consisted of power over war and peace; foreign relations and treaties; national defense; commerce, foreign and interstate; currency; copyrights and patents; post office and post roads; Federal courts of justice; taxation for the foregoing and the general welfare; and "the protection of citizens against unjust or discriminating legislation by any State."[12] This left a large field for the States. As previously mentioned, in the early years of our national history there was much distrust of centralized power, and the rule seemed to be: "In case of doubt, leave it to the States."

The Constitutional Convention also gave much consideration to another division of powers which also had an important bearing on the Federal system. This was the division among the branches of government, executive, legislative, and judicial. The Federal judiciary came to exercise a very important power not explicitly granted; namely, that of final arbiter in its interpretation of the Federal Constitution, which in turn stated the division of authority between the Federal Government and the States.

(b) *Early development.*

Although the Constitution was a very carefully drawn document, there remained a large area of uncertainty as to the division of authority between the Federal Government and the States. During most of the Nation's history, there have been two parties which divided on this issue, one advocating a stronger national government, the other championing the claims of the States. To be sure, these parties have often reversed themselves on specific issues. At all events, it took 70 years and a war between the States to determine that the Union itself was "indestructible" in the sense that no State could secede upon its own motion. Much controversy also centered upon the interpretation of the so-called implied powers, those not stated but thought necessary to make the designated powers effective. In spite of the broad construction of the Constitution developed by Chief Justice Marshall, the Federal Government was judged to have lost prestige to the States by a French observer, De Tocqueville, when he published in 1835 his commentary on democracy in America.[13] Cases of successful State resistance to Federal action in the early days were freely cited, and notwithstanding the recovery of prestige as a result of the successful resistance to secession in the Civil War, and in spite of a developing national economic system, the Federal Government as of 1929 was still characterized by one observer[14] in terms Jefferson had once used—mainly the American department of foreign affairs.

Although this characterization involved some exaggeration,[15] it

[12] James Bryce, The American Commonwealth, vol. 1, p. 33.

[13] Alexis De Tocqueville, Democracy in America: The Republic of the United States of America, and its Political Institutions, Reviewed and Examined (translated by Henry Reeves), New York, A. S. Barnes & Co., no date, first American edition, pt. 1, p. 67.

[14] George C. S. Benson, The New Centralization, Farrar & Rinehart, New York, 1941, p. 7.

[15] A calendar of new Federal agencies and activities added to the Federal directory between 1913 and 1928 will illustrate the exaggeration: 1913, Federal income tax; 1914, Federal Reserve Board; Federal Trade Commission; The Alaska Railroad; 1915, Bureau of Efficiency; 1916, U. S. Shipping Board and Merchant Fleet Corporation; 1917, Inland Waterways Corporation; U. S. Employment Service; Federal Bureau for Vocational Education; 1920, Federal Power Commission; 1921, Bureau of the Budget; 1922, Grain Futures Administration; 1923, Personnel Classification Board; 1924, Federal Oil Conservation Board; 1926, Aeronautics Branch, Department of Commerce; 1927, Federal Radio Commission; 1928, Federal Farm Board (Stuart Chase, Government in Business, Macmillan, New York, 1935, p. 29).

certainly was true in 1929 that the Federal Government played a relatively small part in the life of the average American citizens. This has been described by Bryce as follows:[16]

> An American may, through a long life, never be reminded of the Federal Government, except when he votes at Presidential and congressional elections, lodges a complaint against the post office, and opens his trunks for a customhouse officer on the pier at New York when he returns from a tour in Europe. His direct taxes are paid to officials acting under State law. The State, or a local authority constituted by State statutes, registers his birth, appoints his guardian, pays for his schooling, gives him a share in the estate of his father deceased, licenses him when he enters a trade (if it be one needing a license), marries him, divorces him, entertains civil actions against him, fines him for overspeeding his automobile, declares him a bankrupt, hangs him for murder. The police that guard his house, the local boards which look after the poor, control highways, impose water rates, manage schools—all these derive their legal powers from the State alone.

Although the States, judged by the above statement, seem to have been allowed the power to control the greater part of the citizen's activities, even these governments were limited severely by the Federal Constitution as interpreted by the Supreme Court. The States were bound chiefly by the fourteenth amendment, which prohibits deprivation of liberty and property without due process of law. For example, early State minimum-wage statutes were held void under this fourteenth amendment.[17] Thus, only limited power to police industry was available to either the Federal Government or the States—leaving a no man's land in governmental control.

(c) *Recent development.*

Any person, whether or not carefully schooled in the affairs of government, will immediately appreciate, upon recalling the state of governmental powers in 1929, what a revolution took place during the thirties. The Federal Government found itself confronted with a national emergency of economic origin and had neither the plan nor the machinery for handling such a national crisis. The contest during the New Deal period over the composition and powers of the United States Supreme Court is recent history which needs no elaboration. Although the Supreme Court emerged with its traditional powers and membership, it proceeded to overthrow much well-established doctrine. This development and certain New Deal measures not only greatly enlarged the scope of Federal activities and powers,[18] ranging from social security to the promotion of agriculture; but the Court also unshackled the States in their exercise of

[16] James Bryce, The American Commonwealth, vol. 1, p. 425.
[17] *Adkins* v. *Children's Hospital* (261 U. S. 525 (1923)).
[18] Listed by Benson as follows:

> (*a*) Social security—including public assistance, unemployment compensation, child welfare, old-age insurance, and various public health programs.
> (*b*) Promotion of agriculture.
> (*c*) Conservation of natural resources.
> (*d*) Public works—including both those designed primarily to facilitate construction of desirable works and those designed primarily to alleviate unemployment.
> (*e*) Housing of the population—through direct construction, loans to local authorities, and underwriting of building activities.
> (*f*) Public utility enterprises.
> (*g*) Promotion of private business.
> (*h*) Regulation of labor conditions.
> (*i*) Regulation of business.
> (*j*) Law enforcement.
> (*k*) Specialized education.
> (*l*) General credit and insurance.

G. C. S. Benson, The New Centralization, p. 45.

the police power over industry [19] and widened the interpretation of the "commerce clause" to admit much Federal policing.[20]

It has been customary to speak of the American Constitution as rigid. The term is relative, of course, for the Constitution has been a growing institution subject to constant change by amendment, interpretation, and usage. But amendments have been few and difficult to obtain, interpretation has been in the hands of a usually very conservative Court, and change by usage has been rather limited in scope. Thus, the constitutional system developed a great inertia, overcome only by the extreme gravity of a national crisis and the aggressive onslaught of the New Deal. But great rigidity has now given way to considerable fluidity, and change by interpretation has become an established precedent.

(*d*) *Experience in other countries.*

Some authorities have regarded the federal form of government as a step toward centralization rather than a final form of government. Germany's development is an example of this. The independent states formed a Customs Union in 1834. This was supplanted by the North German Federation in 1867, and the Empire, a true federal government, replaced the Federation in 1871. The Weimar Constitution of 1919, while still providing for a federal state, had strong centralizing tendencies, foreshadowing the unitary state that now prevails.

The United States and Switzerland, also, adopted the federal form as a step toward centralization, and both have increased the scope of the federal government's powers somewhat during their history. Both are still far removed, however, from unitary states, although they have had a federal government much longer than Germany. Australia, Canada, and the Union of South Africa have shorter federal histories, but they too seem to regard the federal form of government as final. At the other extreme, Mexico, Brazil, and Argentina each took a step toward decentralization when the federal government was introduced. In recent years all these states—but particularly Brazil with its 1937 constitution—have been moving toward greater centralization.

2. DIVISION OF THE TAXING POWER [21]

Under the Continental Congress and the Articles of Confederation, the "United States" incurred such great financial difficulties that the credit and prestige of the new union went from bad to worse. The Congress of the Confederacy had no independent powers of taxation and had to get such revenue as it could by begging or coercing the States to levy taxes on its behalf.[22] It was mainly financial necessities which motivated the Constitutional Convention in 1787, and it was to be expected that any constitution which might be proposed would contain much more adequate taxing powers than the Federal Government had previously possessed. The powers granted were quite extensive compared with previous ones, and they were considerably

[19] *West Coast Hotel Co.* v. *Parrish* (300 U. S. 379 (1937)).

[20] *National Labor Relations Board* v. *Jones and Laughlin Steel Corporation* (301 U. S. 1 (1937)); *U. S.* v. *F. W. Darby Lumber Co.* et al. (61 Sup. Ct. 451 (1941)).

[21] Based in part upon Harold M. Groves, Financing Government, Holt, New York, 1939, ch. XIX.

[22] It is curious to observe how the situation has reversed itself in a century and a half. As a practical matter, the Federal Government now has far more effective powers of taxation and borrowing than the States.

enlarged by the sixteenth amendment; but they are far from being all-inclusive. The following major rules for Federal taxation are laid down in the Constitution as amended:

1. "No tax or duty may be laid on articles exported from any State.[23]

2. "* * * direct taxes shall be apportioned among the several States * * * according to their respective numbers * * * and no capitation, or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." [24] It was under this clause that the income-tax law of 1894 was held unconstitutional.[25] In 1913, the sixteenth amendment brought the income tax within the power of Congress by providing that the latter might tax income "from whatever source derived" without regard to apportionment. However, the amendment did not entirely end the controversy over apportionment of taxes aimed at net income. Subsequent decisions of the Court held that any direct tax which is aimed at income, but which is not upon net income as the Court interprets the latter, is still subject to apportionment. Thus, stock dividends were excluded from the base of the Federal income tax.[26] The Court sustained the Federal gift tax [27] on the ground that had been used in sustaining the 1909 Federal corporation income tax,[28] namely, that it was an excise needing no apportionment. Property taxes are subject to the apportionment clause and are thus regarded as largely unavailable to the Federal Government.[29] A capital levy, for example, would in all probability require a constitutional amendment.

3. "* * * all duties, imports, and excises shall be uniform throughout the United States." [30] "This required uniformity is geographic, not intrinsic. A graduated tax, on legacies, granting exemptions * * * or on incomes * * * does not violate this clause of the Constitution," [31] and even geographic uniformity means only that the tax law shall be generally applied, not that it shall be uniform in its effect. Thus a Federal tax may be imposed on objects which exist in some States and not in others.[32]

4. Taxes must not be arbitrary or discriminatory (fifth amendment).

5. The power of the States to tax is limited both by Federal and State Constitutions (though far more by economic circumstances). They are barred by the Federal Constitution from taxing imports and exports, tonnage taxes,[33] and taxes on interstate commerce. (The last prohibition is not specific, but is inferred from the prohibition on export and import taxes and from the commerce clause, which gives Congress power "to regulate commerce with foreign nations, and among the several States, and with the Indian tribes.")[34] Federal treaties take precedence over State taxing powers, and the States must conform to certain general requirements against impairment of the obligation of contract,[35] discrimination against citizens of other States,[36] and deprivation of property without due process of law.[37] By long and complicated development of judicial law, both the States and Federal Government are barred from taxing certain of each other's so-called instrumentalities. The States limit themselves principally through the "uniformity clauses" in State constitutions such as those which provide that taxation must be "equal and uniform." Many attempts by the States to tax income have been nullified by court interpretation of these latter provisions.

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[23] United States Constitution, art. I, sec. 9, par. 5.
[24] Ibid., art. I, sec. 2, par. 3, and sec. 9, par. 4.
[25] *Pollack* v. *Farmers Loan and Trust Co.* (157 U. S. 429; on rehearing, 158 U. S. 601 (1895)).
[26] *Eisner* v. *Macomber* (252 U. S. 189 (1920)).
[27] *Bromley* v. *McCaughn* (280 U. S. 124 (1929)).
[28] *Flint* v. *Stone Tracy Co.* (220 U. S. 107 (1911)).
[29] Once, in 1798, a direct tax of $2,000,000 was apportioned among the States to be levied upon dwellings at a rate of one-fifth of 1 percent of value, on slaves at a rate of 50 cents per head, and on land for the difference between the yield of these two taxes and the amount apportioned to the States. Again, during the War of 1812, a direct tax was levied as above. It yielded approximately $4,000,000 in 1814 and 1815. The last use of this tax by the Federal Government was during the Civil War when a $20,000,000 levy was apportioned among the States for collection (W. J. Shultz and M. R. Cairne, Financial Development of the United States, Prentice-Hall, New York, 1937, pp. 110-111, 141-142).
[30] United States Constitution, art. I, sec. 8, par. 1.
[31] *Bromley* v. *McCaughn* (280 U. S. 124, 138 (1929)).
[32] *Head Money cases* (112 U. S. 580 (1884)).
[33] United States Constitution, art. I, sec. 10, par. 3. Both limitations are qualified with the provision "without the consent of Congress."
[34] Ibid., art. I, sec. 8, par. 3.
[35] Ibid., art. I, sec. 10, par. 1.
[36] Ibid., art. IV, sec. 2.
[37] Ibid., 14th Amendment, sec. 1.

The historical evidence indicates that our Constitution made no attempt to restrict the Federal Government's taxing power in the interest of the States. The restrictions placed on the Federal Government's taxing power—prohibition of export duties and the stipulation that direct taxes shall be levied in proportion to the population—were the result of sectional conflicts rather than a desire to limit the new Government's revenues.

The Southern States had more to lose than the Northern States by export duties, and opposed them accordingly; and a property tax distributed in proportion to the population rather than in proportion to the property itself was in the interests of the South. Moreover "taxation without representation" had been a recent issue, and this was an additional reason for insisting on the apportionment of direct taxes in proportion to the population.[38]

This failure on the part of the States to impose limitations on the new Federal Government or demand reimbursements for lost revenue sources is the more surprising in view of the fact that up to this time most of the States had been levying export or import duties, or both, and some—notably New York and South Carolina—had depended on such revenues in very large measure. However, taxes as a whole were light; the property and poll taxes were well established as sources of State and local revenue; and it seems probable that there was no expectation of these becoming regular sources of Federal revenue. Also, the unhappy experience of the Continental Congress had impressed the framers of the Constitution with the importance of adequate sources of independent revenue for the central Government, and the central Government was relieving the States of one of the costlier Government functions—national defense.

Consequently, the United States was the first Federal Government in history to be provided with an independent and adequate revenue. It was also the first, according to Hart, in which all external commerce was committed to the Union, and the police power left unreservedly to the State.[39]

Later federal governments were influenced in some measure by this example. But greater pressure for revenues, and perhaps other factors, led in most instances either to greater restrictions on the Federal taxing power, or to demands for reimbursement to the States for revenue sources relinquished.

All the federal governments here observed[40] have been granted exclusive power to levy import duties, and most have likewise been given exclusive power to levy export duties. Only in Brazil have export duties been assigned to the States (although in Canada the Province of New Brunswick was permitted to levy an export duty on lumber in the early years of the federation), and only in the United States are export duties prohibited. Export duties have not been widely used in practice, however. Argentina has used them more than any of the other countries, and even here they have never matched import duties in importance and have been dispensed with entirely at times. Mexico also has used them, and has occasionally permitted States to levy them.

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[38] See, e. g., H. Finer, Theory and Practice of Modern Government, New York, 1932, vol. 1, pp. 316-318; and C. J. Bullock, "The Origin, Purpose and Effect of the Direct Tax Clause in the Federal Constitution," Political Science Quarterly, vol. 15, June 1900, pp. 217-239.

[39] A. B. Hart, Federal Government, Ginn, Boston, 1891, p. 50.

[40] Australia, Canada, Germany, Switzerland, Union of South Africa, Argentina, Brazil, Mexico, and the United States.

Internal excises were available originally to all the federal governments except that of Switzerland. Some of the governments were limited, however, in the nature of such levies in the early years, and only the German Government obtained more revenue from excises and other indirect taxes than from customs duties. The United States was alone, among the governments that had power to levy such taxes, in making no use of them in the early years. Except for a brief period during the War of 1812, our Government did not levy any important excises until the Civil War.

3. DEVELOPMENT OF OVERLAPPING TAXATION

Until 1861, the Federal Government subsisted largely upon receipts from the tariff and the sale of public lands. During the Civil War, under the pressure of sudden necessity, it resorted to income, inheritance, and a wide range of excise taxes. Several of the latter, particularly those on alcoholic beverages and tobacco, were retained after the war and continued to provide substantial revenue. Nevertheless, the tariff still held the major position as a Federal revenue source. The early attempt (1894) to inaugurate an income tax in peacetime proved abortive because of a Supreme Court decision.[41] During the Spanish-American War, death taxes were again employed, but only for the emergency. Thus, down to the eve of the First World War, the Federal tax system was a very simple one and conflict with the States was avoided because the Federal Government confined itself largely to sources which the States were forbidden to tax (customs) or which they had never seen fit to employ widely (excises). The States meanwhile were raising their revenue mostly from the general property tax, a field largely protected from Federal encroachment by the Federal Constitution.

But the States, in the early years of the twentieth century, began to complain considerably of the inadequacy of the property tax, and they began to develop supplementary sources of revenue. The Federal Government, partly under the stimulus of the First World War emergency, also embarked upon a program of broadening its revenue system. The Federal Government and the States (to borrow a figure from Robert M. Haig) [42] took to fishing in the same streams. And (to continue with Haig's figure) both sovereign governments used some very high-powered tackle, not excluding (perhaps) dynamite itself. Alcoholic beverage and gasoline taxes are universal among the States and the death taxes nearly so; income taxes are levied in about two-thirds, tobacco taxes in well over half, and excises on electrical energy and amusements in several of the States. All these sources are taxed heavily by the Federal Government. Additional minor overlapping occurs in the case of stock-transfer taxes, and recently the Federal Government has invaded an area long occupied by the States, the motor-vehicle license-tax field. The need for more revenue, and the diversification of wealth and income have brought new taxes into the revenue systems of both the States and the Federal Government. This has created many problems which it is the task of this study to explore.

Some quantitative evidence of the extent of overlapping revenue sources is presented in tables 1 and 2 and charts 1 and 2 following.[43]

[41] *Pollack v. Farmers Loan and Trust Co.* (157 U. S. 429; on rehearing, 158 U. S. 601 (1895)).

[42] Robert Murray Haig, "The Coordination of Federal and State Tax Systems," Proceedings of the National Tax Association, 1933, p. 223.

[43] This material, including table and charts, is based largely upon work done by Loren D. Melton.

The date of adoption by Federal and State Governments, which is given for most of the mutually employed tax sources, indicates the level of government which pioneered the field and that level which may have "muscled in on a good thing" after the field had been well cultivated by the other. The chronology of adoption is followed by a statement of the number of States imposing the tax, and the extent of municipal overlapping, if any. Table 2 shows the extent of overlapping in quantitative terms. Charts 1 and 2 indicate the extent to which Federal and State Governments now rely on the same major sources of tax revenue.

TABLE 1.—*Year of adoption of major overlapping taxes of the Federal and State governments* [1]

State	Net income taxes		Death taxes	Gift taxes	Alcoholic beverage		Motor-vehicle license	Motor fuel taxes	Stock transfer taxes	Tobacco taxes
	Corporation	Individual			Gallonage taxes	Liquor monopolies				
Federal	1909	1913	1916	1932	1933		1942	1932	1917	1862
Alabama	1933	1933	1931			1937	1911	1923		1935
Arizona	1933	1933	1912		1933		1912	1921		1935
Arkansas	1929	1929	1901		1935		1911	1921		1929
California	1929	1935	1893	1939	1935		1905	1923		
Colorado	1937	1937	1901		1933		1913	1919		
Connecticut	1915		1889	1937	1937		1903	1921		1935
Delaware		1917	1869		1933		1905	1923		
District of Columbia	1939	1939	1936		1934		1907	1924		
Florida			1931		1935		1911	1921	1931	[2] 1913
Georgia	1929	1929	1913		1937		1910	1921		1937
Idaho	1931	1931	1907			1935	1913	1923		
Illinois			1895		1934		1907	1927		1941
Indiana			1913		1933		1905	1923		
Iowa	1934	1934	1896			1934	1904	1925		1921
Kansas	1933	1933	1909		[3] 1937		1913	1925		1934
Kentucky	1936	1936	1906		1934		1910	1920		[2] 1906
Louisiana	1934	1934	1828	1940	1934		1914	1921		1932
Maine			1893			1934	1905	1923		1941
Maryland	1937	1937	1844		1933		1904	1922		[2] 1890
Massachusetts	1919	1916	1891		1933		1903	1928	1914	1939
Michigan			1893			1933	1905	1925		
Minnesota	1933	1933	1875	1937	1934		1903	1925		[2] 1919
Mississippi	1912	1912	1918		[4] 1934		1912	1922		1934
Missouri	1917	1917	1895		1934		1903	1925		
Montana	1917	1933	1897			1933	1913	1921		[2] 1921
Nebraska			1921		1935		1907	1925		[2] 1919
Nevada					1935		1913	1923		[2] 1919
New Hampshire		1923	1878			1934	1905	1923		1939
New Jersey			1892		1933		1903	1927		
New Mexico	1933	1933	1919		1934		1912	1919		
New York	1917	1919	1885		1933		1901	1929	1905	1939
North Carolina	1921	1921	1847	1937		[4] 1934	1909	1921		[2] 1937
North Dakota	1919	1919	1903		1936		1911	1919		1927
Ohio			1913			1933	1906	1925		1931
Oklahoma	1931	1915	1907	1941	[3] 1939		1911	1923		1935
Oregon	1929	1931	1903	1933		1933	1905	1919		
Pennsylvania	1937		1826			1933	1903	1921	1915	1937
Rhode Island			1916	1942	1933		1904	1925		1939
South Carolina	1922	1922	1922		1935		1906	1922	1923	1923
South Dakota	1935	1935	1905		1935		1905	1922		1923
Tennessee	1923	1929	1893	1939	1939		1905	1923		1925
Texas			1907		1935		1907	1923	1941	1931
Utah	1931	1931	1901			1935	1909	1923		1923
Vermont	1931	1931	1896			1934	1904	1923		1937
Virginia	1916	1916	1844	1934		1934	1910	1923		[2] 1914
Washington			1901	1941		1934	1905	1921		1935
West Virginia		1935	1887			1935	1905	1923		[2] 1901
Wisconsin	1911	1911	1903	1933	1934		1905	1925		[2] 1915
Wyoming			1903			1935	1913	1923		

See footnotes at end of table.

TABLE 1.—*Year of adoption of major overlapping taxes of the Federal and State governments*—Continued

State	Net income taxes		Death taxes	Gift taxes	Alcoholic beverage		Motor-vehicle license	Motor fuel taxes	Stock transfer taxes	Tobacco taxes
	Corporation	Individual			Gallonage taxes	Liquor monopolies				
Number of States	32	33	47	12	31	17	48	48	6	39
					Total, 48					
Extent of municipal overlapping, 1941	None	(5)	None	None	(6)		(7)	(8)	None	(9)

[1] In addition to these taxes, property taxes have been the foundation of the tax structure of local government since the beginning of the Republic and a principal source of State revenue as well. Today 14 States have practically given up State general property taxes (California, Delaware, Illinois, Michigan, New Hampshire, New York, North Carolina, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, Vermont, Wisconsin). Most of these have abandoned the tax since 1930. No Federal property tax is imposed. State capital stock, corporate excess, or franchise taxes paralleled the development of the corporate form of business enterprise in the ninteenth century, and States have traditionally dominated this field. The present Federal capital-stock tax was first enacted in 1934. Under the impetus of the 90-percent credit allowed against Federal unemployment compensation pay-roll taxes, all States have enacted pay-roll taxes since 1936.

[2] License, not excise. Montana license repealed in 1939.

[3] On light beer and (for Mississippi) wine.

[4] County monopoly.

[5] Philadelphia, the only instance.

[6] Municipal liquor taxes are generally restricted to licensing of vendors for regulatory purposes. Local licensing is almost universally employed. New Orleans has excise tax on spirits, wine, and beer; and a few other local governments have such excises.

[7] Rather general in Alabama, Arkansas, Georgia, Illinois, Kentucky, Missouri, Nebraska, North Carolina, Tennessee, and Virginia. Operators' licenses are municipally imposed in 20 States.

[8] In 6 counties in Alabama, 4 counties in Mississippi, and 153 cities and towns in Florida, Missouri, Nevada, New Mexico, and Wyoming. Municipal motor-fuel taxes have no doubt been prevented by State sharing of motor-fuel taxes with municipalities.

[9] Birmingham, Denver, Kansas City, Mo., St. Louis, and numerous Florida cities have cigarette taxes A New York City tax was repealed when the State tax was introduced in 1939.

TABLE 2.—*Federal, State, and local revenues from overlapping sources, fiscal years ending in 1941* [1]

Tax	Amount of revenue (millions of dollars)				Percent of total revenue in each jurisdiction				Percent of total revenues from each source
	Total	Federal	State	Local	Total	Federal	State	Local	
Death and gift	529	407	121	1	100	77.0	22.9	0.1	3.1
Corporation income	2,245	2,053	190	2	100	91.5	8.4	.1	13.2
Individual income	1,671	1,418	233	20	100	84.8	14.0	1.2	9.8
Tobacco	805	698	107	(2)	100	86.7	13.3	(2)	4.7
Alcoholic beverages [3]	1,192	820	337	35	100	68.8	28.3	2.9	7.0
Motor-vehicle licenses	441	(4)	417	24	100	----------	94.6	5.4	2.6
Motor fuel	1,264	343	914	7	100	27.1	72.2	.7	7.5
Stock transfer	24	12	12	--------	100	50.0	50.0	--------	.1
Miscellaneous corporation	415	167	208	40	100	40.1	50.1	9.8	2.5
Pay roll	1,899	[5] 993	901	5	100	52.3	47.4	.3	11.2
Total overlapping [6]	10,485	6,911	3,440	134	100	65.9	32.8	1.3	61.7
Independent [7]	6,501	907	1,122	4,472	100	13.9	17.3	68.8	38.3
Total taxes [8]	16,986	7,818	[8] 4,562	4,606	100	46.0	26.8	27.2	100.0

[1] District of Columbia is included with local governments. Territories and island possessions are excluded.

[2] $155,000, which is less than 0.1 percent of the total.

[3] Includes excises, licenses, and liquor monopoly profits.

[4] The Federal use tax ($5 a year for each vehicle) which was enacted in 1941 did not go into effect until Feb. 1, 1942.

[5] Includes $61,347,000 of contributions to the railroad unemployment trust fund.

[6] Because certain Federal taxes do not overlap State taxes in all States, the total of Federal overlapping taxes shown is an overstatement.

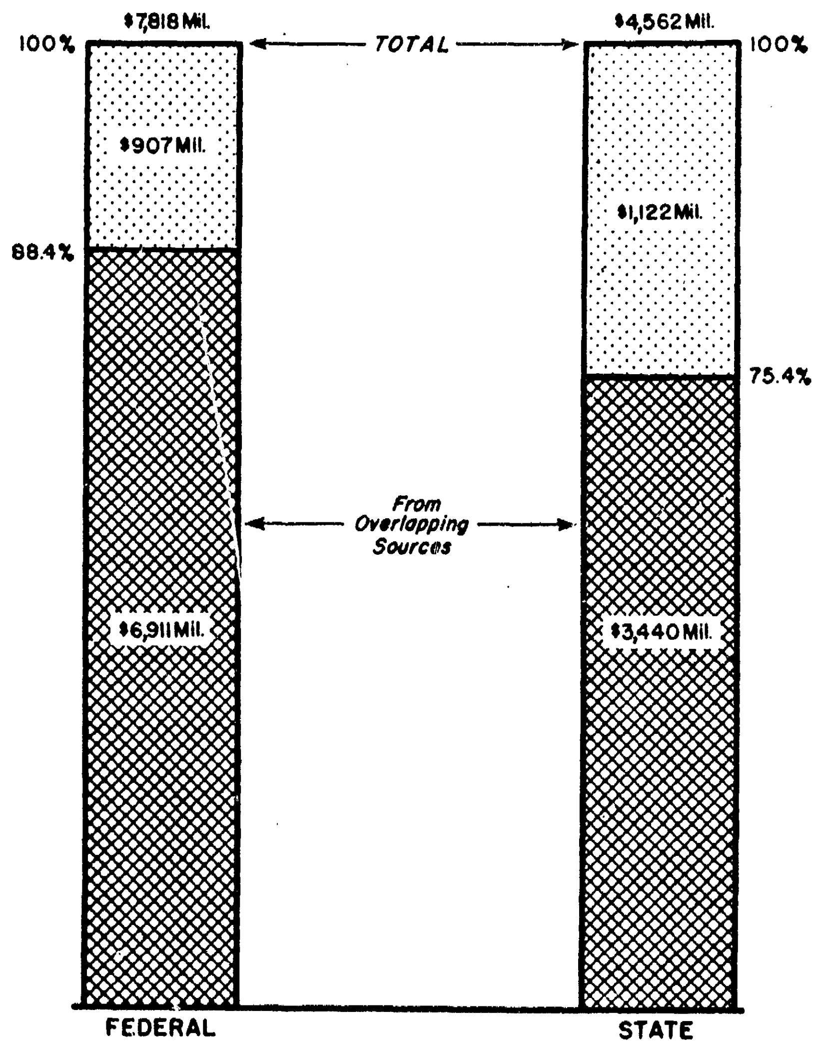
[7] Practically all of the "independent" State and local taxes are employed by both State and local governments.

[8] Includes State liquor monopoly profits amounting to $63,000,000.

Source: Adapted from Bureau of the Census, Financing Federal, State, and Local Governments: 1941.

PERCENTAGE OF FEDERAL AND STATE TAX REVENUES DERIVED FROM OVERLAPPING SOURCES

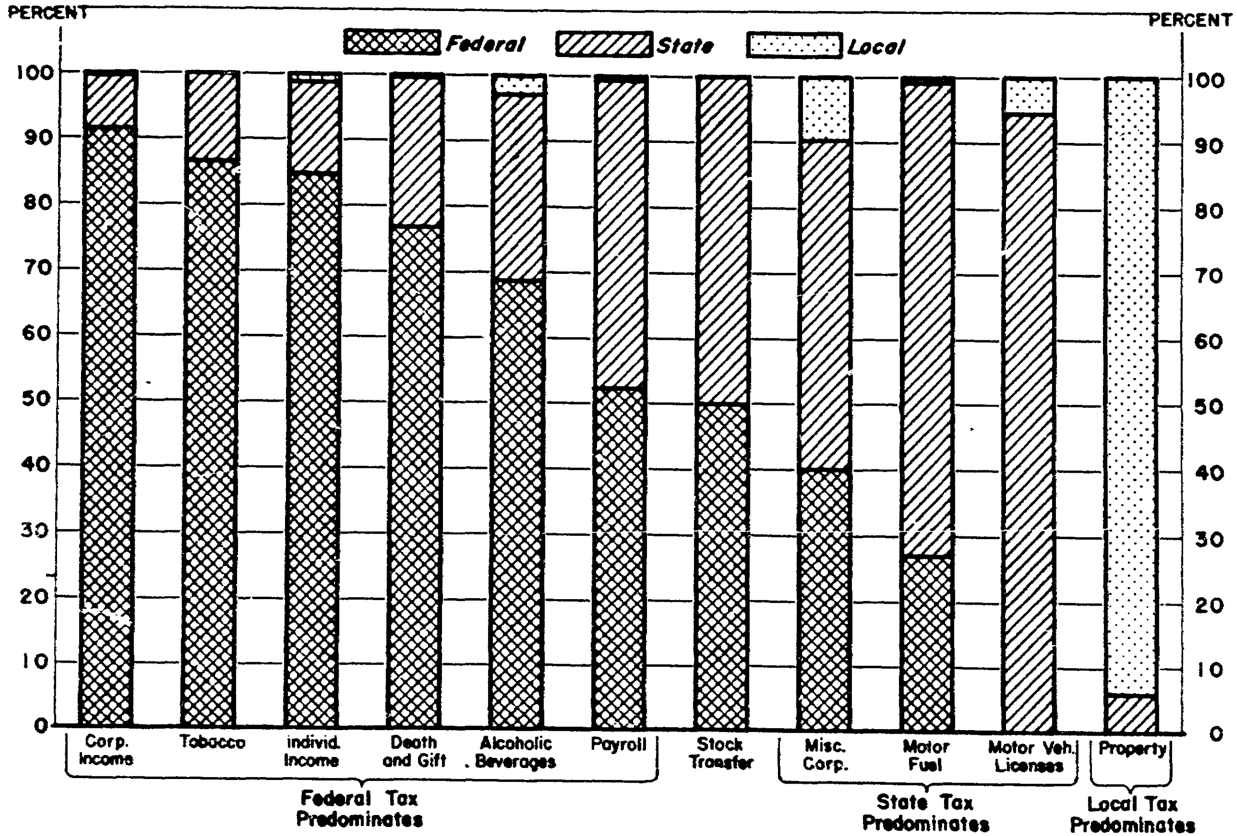
Fiscal Years Ending in 1941



Source: Table 2

CHART 1.

EXTENT OF OVERLAPPING IN MAJOR TAX SOURCES
Fiscal Years Ending in 1941



Source: Table 2. Property tax figures adapted from Bureau of the Census, Financing Federal, State and Local Governments: 1941.

CHART 2.

Summarizing the facts presented by these tables and charts one may make the following observations:

1. Overlapping in Federal and State tax sources exists in significant degree with respect to some 10 sources of tax revenue, including most of the major sources, and comprising approximately 62 percent of all Federal, State, and local tax revenues. The tax sources jointly employed by Federal and State Governments accounted for 88.4 percent of all Federal tax collections and 75.4 percent of all State tax collections in 1941.

2. Of the 10 sources in which Federal-State overlapping exists, the Federal Government dominates (that is, collects a major proportion of total revenues from the tax) with respect to the following: (1) The net income tax,[44] (2) death tax, (3) gift tax, (4) alcoholic beverage excise taxes, (5) tobacco excise taxes, and (6) pay-roll taxes. State governments continue to dominate in (1) the taxation of corporations and public utilities (business taxes), (2) motor-vehicle fuel taxes, and (3) motor-vehicle licenses, but are in the process of yielding supremacy to the Federal Government in the taxation of stock transfers, and feel themselves threatened in the field of motor-vehicle taxation. Federal domination of fields in which it predominates is quantitatively greater than that of the States where the latter have supremacy.

3. No major source of tax revenue, initiated during times of peace, has been relinquished by the Federal Government to the States.

4. Among these 10 overlapping Federal-State tax sources, municipal overlapping is found in some degree with respect to (1) income taxes, (2) tobacco taxes, (3) corporation and business licenses, (4) motor-fuel taxes, (5) motor-vehicle licenses, and (6) liquor taxes.

5. Overlapping in the major source of local revenue—the property tax—exists only among State and local governments, with a noticeable trend toward relinquishment of this source to local subdivisions. This property tax overlapping, however, does not involve administrative duplication to the extent found in Federal-State overlapping sources, for State and local assessment and collection of property taxes have always been integrated in the main.

4. SOCIAL AND ECONOMIC INTEGRATION [45]

(a) The development of industrial concentration.

Observing a considerable trend toward an extension of the powers and activities of the National Government, even at the close of the nineteenth century, James Bryce cited "the increasing power of incorporated companies and combinations of capitalists" as a principal cause of this development. He also noted the growing belief that the regulation of such aggregations "cannot be effective unless it proceeds from the Federal authority and applies all over the Union." [46] It was not until 1890 that agriculture lost its position as the predominant economic activity of the country. By 1890 the net value of manufactured products exceeded the value of agricultural products, and by 1920 the number of people engaged in manufacturing exceeded the number engaged in agriculture.[47] No useful purpose would be

[44] Quantitative data on the yield of these taxes and their division as between Federal and State Governments will be found in ch. V.

[45] Based in part upon special monograph prepared for this study by Russell Hinckley, Quantitative Evidence of Interdependence in the Economy.

[46] James Bryce, The American Commonwealth, vol. 1, p. 344.

[47] Chester W. Wright, Economic History of the United States, McGraw-Hill, New York, 1941, p. 609.

served by citing here the voluminous evidence [48] of industrial concentration but a few illustrations may be selected at random. In 1929, corporations were estimated to account (in terms of income produced) for about 92 percent of manufacturing, about 86 percent of transportation and other public-utility business, about 63 percent of trade, and 57 percent of all business excluding government but including agriculture.[49] Concentration within the corporate field is also very striking. In 1930, the combined assets of the 200 largest nonbanking corporations in the United States amounted to nearly half the nonbanking corporate wealth in the country.[50] It is said that the American Telephone & Telegraph Co. alone controlled more wealth in 1932 than the combined wealth of 21 States.[51] The net income of the General Motors Co. for 1941 was about two-thirds as large as the budgetary revenues of New York State. It is a well-known fact, of course, that these great business institutions are no respecters of State boundary lines. They frequently incorporate outside the State in which they have their main business office; production itself often extends into several States; sales offices are even more widespread; and supply of labor and raw materials, and the market for the product, are likely to cover the widest radius of all.

The General Motors Corporation, incorporated in Delaware, and with its principal place of business in Detroit, alone accounted for over 40 percent of American pre-war production of automobiles, and for 35 percent of the world's total. In 1938 the three leading producers—Ford, General Motors, and Chrysler—accounted for 90 percent of all new cars registered.[52]

Prior to the defense period (1938), the General Motors Corporation had 250,000 employees and 400,000 stockholders, and it operated 110 plants for manufacture and assembly in 14 States and 18 foreign countries. Principal plants and properties were listed in 15 States, and timber and other properties in 4 additional States.[53] Sales and service branches and parts-warehouses were maintained in all principal cities, and the product was sold in every State. The Chevrolet division alone, from 9 regional offices supervised activity of 8,700 dealers employing 22,000 salesmen. The industry annually used some 120,000,000 pounds of rubber, 150,000,000 pounds of cotton, 200,000,000 board feet of lumber, and 9 percent of domestic steel output.[54]

The United States Steel Corporation is such a vast enterprise that an analysis of its plants and operations by industrial engineers required a 204 volume report. The top holding company, incorporated in New Jersey and with principal offices in New York City, controls the policies, finances, and affairs of a cement company, of 15 railroads with 1,000 miles of track, 3 steamship companies (68 vessels on the Great Lakes and 27 in ocean traffic), and of a New Jersey shipbuilding company. The operating and selling corporation, incorporated in Delaware and with headquarters in Pittsburgh, handles operation of

[48] See Temporary National Economic Committee, Investigation of Concentration of Economic Power, Monograph No. 29, 76th Cong., 3d sess., The Distribution of Ownership in the 200 Largest Nonfinancial Corporations; Monograph No. 27, 77th Cong., 1st sess., The Structure of Industry.

[49] Twentieth Century Fund, Big Business, New York, 1937, p. 17.

[50] A. A. Berle and G. C. Means, The Modern Corporation and Private Property, Macmillan, New York, 1935, p. 19.

[51] Berle and Means, op. cit.

[52] Temporary National Economic Committee, Monograph No. 27, op. cit.

[53] Moody's Manual of Investments, Industrial Securities, Moody's Investors' Service, New York, 1940, p. 2581.

[54] U. S. Senate Committee on the Judiciary, Hearings on S. 10, Federal Licensing of Corporations, 75th Cong., 1st sess., pt. 1, January 25, 29, 1937.

30 active subsidiaries, and of ore deposits, coal mines, and limestone quarries. Many plants are operated by 6 large steel-producing subsidiaries: Carnegie-Illinois, Tennessee Coal & Iron, National Tube, American Steel & Wire, American Bridge, and Columbia Steel. Huge interstate movements are generated by shipment of the final product and the 56,000,000 tons of raw material annually required in its production. With over 260,000 workers and a sales force of 7,500, and about 35 percent of total domestic steel ingot capacity (1938), the national character of the corporation is apparent.[55] Principal plants and properties are located in at least 23 States, and branches and offices in many others. Limestone properties alone are held in 16 States, and one subsidiary (Oil Well Supply) operates branches in 17 States.

These developments in industrial concentration produced profound problems in Federal-State-local fiscal relations and in taxation at all levels of government. These economic giants created confusion between the corporate entity and the security holder, and between intangible corporate assets and corporate physical property; their physical plants were unique and had no "market value"; because of these facts, they undermined the (already none-too-popular) general property tax. States were thus driven to introduce business taxes; the Federal Government, for other reasons, also entered this field, thereby adding the complication of overlapping. Between the two sets of jurisdictions, great confusion in the pattern of business taxation was created. State taxation of interstate business confronted the well-known problems of apportionment, multiple taxation, and migration of capital. Where a corporation has factories in two States, a sales office in a third, and a market for its products and a recruiting ground for labor and raw materials covering a still wider area, the problem territorially of earmarking the fruits of this institution's labor is exceedingly troublesome. State competition for the business of issuing corporation charters, and for taxes on privileges attending such business, results in "the slow abdication of effective State control" through the grant of increasingly generous charter provisions. There arises also some support for the view that taxation is an important instrument of social control (whether or not intentionally so used) and that such social control, at least as applied to business concentration, should be national in scope and perspective.

(*b*) *The development of high productivity.*

During the last 40 years of the nineteenth and thus far in the twentieth century, the rate of technological advance has probably been more rapid than ever before in the world's history.[56] In 1937 only about one-third as many man-hours of factory work went into the fabrication of a given quantity of goods as 38 years earlier.[57] Manufacturing output itself more than quadrupled during the first four decades of the twentieth century.[58] The decade from 1920 to 1930 was said to have exceeded all previous decades in technological achievement.

All of this has a bearing on the problem of Federal-State-local fiscal relations. The view has become quite common that such productivity

[55] "Managers of Steel," Fortune, March 1940, pp. 64-67.
[56] Chester W. Wright, Economic History of the United States, p. 667.
[57] Solomon Fabricant, The Relation Between Factory Employment and Output Since 1899, National Bureau of Economic Research, Occasional Paper 4, 1941, p. 7.
[58] Ibid., p. 37.

entitles all members of society to a minimum of the good things of life—including nutrition, shelter, and health. These matters had been regarded as no concern of government, or at most of concern to local governments. Thus a whole new horizon of government welfare activities was opened. The fiscal implications of these new interests will be considered in greater detail below.

(*c*) *Tendencies toward instability and insecurity.*

The wide fluctuations in the economy that developed during the thirties and the shortage of opportunity which prevailed during that period are a familiar story. Even before the depression there was evidence of scarcity of opportunity. In the first half of 1933, factories making durable goods of all kinds employed only 44 percent as many men as in 1929; the corresponding figure for lumber mills was 45 percent; for cement mills, 44 percent; and for steel mills, 54 percent. Moreover, many of those employed were only on part time.[59] "Fewer wage earners were employed in factories in 1932 than during any calendar year for more than a generation.[60]

These tendencies toward instability and insecurity, combined with the increase in productive capacity discussed above, created the new interest in "fiscal policy" which blossomed during the thirties. Much attention was brought to bear on such hitherto largely neglected problems as the complicated relationships of total saving, total investment, purchasing power, and national income to full employment. In respect to the fiscal system, this called for a reexamination of the over-all tax system in terms of its economic effects. It also meant a reexamination of the division of financial responsibility for the various functions of government. For example, while recreation had been and still continues to be predominantly a local function, the Federal Government found itself financing new municipal recreation facilities, not for their own sake but to stimulate business and provide employment.

(*d*) *Growth of interdependence.*

Most important of all among the factors which contributed to the development of the fiscal coordination problem was the rapid growth of economic and social interdependence. Mention has been made of the tendency of business establishments to expand their facilities of production and sale beyond State boundary lines. Although political factors have tended to prevent the development of international territorial specialization and trade, the same factors have, to only a very limited extent, operated at the interstate level. The degree of interstate economic interdependence and specialization, and the survival of some mercantilistic resentment toward it, are humorously portrayed by James Harvey Rogers:[61]

Nothing wrong with Texas except entirely too many of us get up in the morning at the alarm of a Connecticut clock, button a pair of Ohio suspenders to a pair of Chicago pants. Put on a pair of Massachusetts shoes, wash in a Pittsburgh tin basin, using Cincinnati soap and a cotton towel made in New Hampshire, sit down to a Grand Rapids table, eat pancakes made from Minneapolis flour spread with Vermont maple sirup and Kansas bacon fried on a St. Louis stove. Buy fruit put up in California, seasoned with Rhode Island spices, sweetened with Colorado

[59] P. W. A. and Industry, Bul. No. 658, Bureau of Labor Statistics, 1938.
[60] Solomon Fabricant, op. cit., p. 4.
[61] "From State Rights to State Autarchy," Harpers, vol. 177, November 1938, p. 646.

sugar, and pay our bills with a check made in New York. Put on a hat made in Philadelphia, hitch a Detroit mule fed on Oklahoma gasoline to an Ohio plow, and work all day on a Texas farm covered with a New England mortgage, send our money to Ohio for tires, wondering why Texas taxes are $2.75 per acre while Ohio farmers pay $1 tax and drive on paved roads, and at night we crawl under a New Jersey blanket to be kept awake by a bulldog, the only home product on the place, wondering all the time where all the money went in this wonderful State of ours.

Modern interdependence takes myriad forms of which a few may be listed as follows: Interstate trade is large and growing; travel for pleasure is extensive and covers long distances; communication by mail, telephone, and telegraph is extensive and a very large part is nonlocal; interstate and intermunicipality migration is no new phenomenon but it continues in significant proportions; nation-wide circulation of a single magazine or newspaper is a frequent occurrence.

(1) *Territorial specialization.*—To choose a few specific examples of territorial specialization and resulting interdependence, the northeastern region depends upon the rest of the nation for wheat, flour, a large part of its fresh meats, fruits, vegetables, canned goods. It also imports heavy lumber and wood products, newsprint, cotton, and petroleum. It supplies most of its own coal and iron. It sells such items as heavy machinery, coal, steel, railway equipment, paint, varnish, glass, textile and leather goods, paper and tools. Typical of the metropolitan food is the often cited fact that New York City seldom has more than 60 days' supply on hand. An analysis of shipments of agriculture commodities readily shows the extent of dependence. Eggs are shipped to New York City, for example, from every State on the Pacific coast, from nearby Massachusetts and rural New York State, and as far southwest as Texas. The bulk of the shipments are received from Illinois, Indiana, Iowa, and Missouri. For 1930 to 1932, New York City received live and dressed poultry from every State in the Union except Arizona—25.4 million pounds were received from New York State as compared to such shipments as 41 million pounds from Iowa; 26.4, Indiana; 18.7, Texas; 40.6, Illinois; 41.1, Missouri; 25.1, Minnesota.[62]

The fact that 75 percent of all manufacturing activity (1935) is carried on in about 200 of the total 3,052 counties is one of the most striking single evidences of the development of a high degree of interdependence.[63]

(2) *Interstate movement of electric power.*—During 1940, a total of 29,000,000 kilowatt-hours of electrical energy was reported by electric-utility companies as moving across State lines and international boundaries. This was 20 percent of the total generated for public use in the United States. Eight hundred and twelve transmission and distribution lines were used for transmission across State lines.[64]

[62] Philadelphia, in 1935, drew 28 percent of its fluid cream from Wisconsin as compared to 24 percent from Pennsylvania; 17.6 percent was derived from Indiana and large quantities from other States of the Middle West (U. S. Senate hearings on S. 10, op. cit., pt. 2, 1937, p. 175). New York City received butter from every State between Massachusetts and California and as far south as Louisiana and Texas; 24 percent of the supply of butter came from Minnesota, 30.5 percent from Iowa, 11.2 percent from Nebraska, and 10.6 percent from Illinois in 1935 (U. S. Senate hearings on S. 10, op. cit., pt. 2, 1937, p. 174). This type of evidence of interstate movements of such commodities could be multiplied endlessly. Michigan alone employs approximately two-thirds of all automobile production workers. The Mountain and Plains States, on the other hand, import most of their finished goods and many other commodities. The Southwestern States produce over 25 percent of the Nation's cotton and 40 percent of the crude oil. Organization of manpower and material of the regions is intricate.

[63] One-fourth of all manufacturing establishments were in 7 counties in 1929, one-half in 53, and three-fourths in 393. One-fourth of the manufacturing wage earners were in 11 counties in 1929, one-half in 51, and three-fourths in 209. Bureau of Foreign and Domestic Commerce, Manufacturing Market Statistics, Domestic Commerce Series, No. 67, 1932, p. 4.

[64] Federal Power Commission, Movement of Electrical Energy Across State Lines and International Boundaries, 1940, p. 3.

(3) *Transportation.*—The wide extent of domestic markets for standard goods, the rise of far-flung business operations, and the unity and interdependence of the people is largely attributable to cheap and efficient transportation. It is estimated that average travel per inhabitant increased from 500 miles per year in 1920 to some 2,000 miles per year in 1939, largely as a result of motor-vehicle development.[65] In 1939, with two world's fairs in operation on opposite coasts, highway motor travel reached an all-time peak. It was estimated that $5,000,000,000 was spent in the course of motor travel in that year, and that over 52,000,000 people vacationed in some 15,000,000 cars.[66]

The rapidity of railroad transportation is illustrated by streamlined passenger train runs of 40 hours between San Francisco and Chicago, and 16 hours between Chicago and New York. Freight can be moved from southern California to New York in 196 hours.[67] Average rail-freight speeds (including all stops between terminals) increased from 11.5 to 16.7 miles per hour from 1921 to 1939.

Over the years there has been a marked increase in the average length of freight hauls and passenger journeys. In 1890, average journey per passenger was 24 miles as compared to 50 miles in 1939 (class I, II, and III railroads). Average haul per ton of freight in 1890 was 243 miles (United States as a system) and 129 miles (individual railway). In 1939 these comparable figures were 351 and 194 miles, respectively. These averages reflect in part, of course, the reduction in shorter haul traffic handled as a result of motor-vehicle competition.[68] In 1938, Pullman passengers traveled an average of 532 miles. An analysis of average hauls for individual commodities indicates some of the extreme distances involved in individual hauls as a result of regional specialization.

The average haul for oranges and grapefruit was 2,126 miles in 1932, for fresh vegetables 2,063 miles, and for live poultry 1,207 miles. The average haul for bituminous coal was 362 miles, for wheat 319 miles, and for iron ore 134 miles.[69]

Almost 293,000,000,000 motor-vehicle miles were traveled in 1940. Nearly 23,000,000,000 miles of this was outside of the State of registration. Over 3,000,000,000 miles of truck travel in foreign States is responsible for important interstate movements of many commodities, such as fruits, vegetables, eggs, butter, poultry, and livestock.[70]

(4) *Communication.*—In 1935 approximately 21 percent of all toll telephone messages were interstate in character.[71] In 20 years, radio has come to rival the press in its influence of public opinion, as a political factor, as a source of news and information, and as an advertiser of goods in the national market. In 1930 the radio audience

[65] National Resources Committee, Technological Trends and National Policy, June 1937, p. 180.

[66] Temporary National Economic Committee, Investigation of Concentration of Economic Power, Hearings, pt. 29, Interstate Trade Barriers, 1941, p. 16078.

[67] By air, of course, all major cities except Portland, Maine, and points north, can be reached from San Francisco in 24 hours (to New York, 16 hours). Air mail lines expanded from 3,597 miles in 1926 to 29,588 miles in 1937.

[68] Interstate Commerce Commission, Annual Reports on the Statistics of Railways in the United States, 1929, 1939.

[69] Federal Coordinator of Transportation, Freight Traffic Report, Appendix I, 1935.

[70] Automobile Manufacturers' Association, Automobile Facts and Figures 1941, p. 70. Total motor-vehicle registrations (passenger and truck) increased from 4 in 1895 to 32,025,365 in 1940. On the latter date there were 27,434,979 registered passenger cars, 4,590,386 trucks, and 427,496 unregistered publicly-owned vehicles.

[71] Report of the Federal Communications Commission, Investigation of the Telephone Industry in the United States, H. Doc. 340, 76th Cong., 1st sess., 1939, p. 362.

included 12,000,000 families, and in 1941 over 30,000,000. The 30.6 million radio sets in homes (1941) represented practically 1 to a family. In addition, there were 9,000,000 in cars, and 16.4 million "extra" sets in offices, camps, etc.—a total of 56,000,000.[72] Surveys have disclosed that the 10 most popular programs reach between 10 and 25 percent of the total potential audience.

In the field of publications there were 20 general magazines in 1939 with a circulation of over 1,000,000 each, and a combined circulation of 45,000,000. In addition, there were some 150 "pulp" magazines with a combined circulation of 10 millions. The Curtis Publishing Co.'s publications have grown in circulation from 750,000 in 1898 to a current figure of over 10,000,000.

The motion-picture industry, producing some 400 films a year, and entertaining approximately 88,000,000 persons per week, also exerted an impressive national influence on manners, speech, ideas, and buying habits.[73]

(5) *Interstate migrations of population.*—The volume of interstate migration and rural-urban interchanges of population has been the subject of much inquiry and is constantly cited in support of plans for maintenance of national minimum standards of public services in such fields as education, health, and welfare.

From the days of first settlement, migrations have been taking place. By 1850 it is estimated that the original colonies had lost over 2,000,000 people to States between the Appalachians and the Mississippi River. In 1930, 5,000,000 persons born east of the Mississippi were living west of the river.[74]

During the First World War, large temporary agricultural migrations occurred. Montana, for example, registered a population increase of 46 percent in the 1910-to-1920 decade, and a decrease of 2 percent from 1920 to 1930. By 1900 the New England and Middle Atlantic States began to attract more population than they were losing, and by 1930, the States of the northeast quadrant contained over 3,000,000 persons born south of the Mason-Dixon line and nearly 1,650,000 born west of the Mississippi River.[75]

During the twenties the mobility of population was so extreme that almost every State both gained and lost a significant portion of its native-born population. In 1930 every State except Maine, Vermont, Delaware, Utah, and Nevada contained more than 100,000 residents born in other States. In the Nation as a whole, 23 percent of the total native population (22,000,000 whites and 3,000,000 Negroes) were living outside the States in which they were born.

Between 1920 and 1930 the Nation's farm population decreased by over 1,000,000. A net migration took place away from the farms of every State except California, Massachusetts, and Rhode Island.[76] In two-thirds of the States, this net migration exceeded the natural increase; hence, the farm population decreased in actual number.

That all of this interdependence has great significance in the province of government is at once apparent. One writer goes so far as to say that "commerce renders the mere convenience of uniformity [in

[72] Wall Street Journal, January 24, 1942, p. 11.
[73] "The Culture of Democracy," Fortune, February 1940, pp. 76-84.
[74] National Resources Committee, The Problems of a Changing Population, May 1938, p. 83.
[75] Ibid., pp. 83 ff.
[76] National Resources Committee, op. cit., p. 85.

laws] an almost imperious necessity."[77] Commerce and communication also make for the uniformity of outlook and customs upon which greater uniformity in law can be based. More important is the fact that what was once of purely local concern for government ceases to be so under modern conditions. This has been well expressed by Sidney Webb, writing about a similar condition in England:[78]

> We cannot afford to let the inhabitants of Little Pedlington suffer the penalties of their own ignorance or their own parsimony, because the consequences fall, not on them alone, but also upon the neighboring districts, upon everyone who passes through this benighted area, upon all those who have intercourse with them, even upon the community as a whole, whose future citizens they are producing. We see this clearly enough when it is a question of infectious disease. We cannot allow Little Pedlington to be free, if it chooses, to have as much smallpox and enteric fever—not to say cholera and bubonic plague—as its inhabitants choose to submit to, rather than take preventive measures which they dislike. We have equally no reason to put up with horribly bad roads which are all they may wish to pay for. If they are permitted to bring up their children in ignorance, to let them be enfeebled by neglected ailments, and to suffer them to be demoralized by evil courses, it is not the Little Pedlingtonites alone who will have to bear the inevitable cost of the destitution and criminality thus produced. Hence modern administrative science is forced to recognize that we are all, in the plainest sense, "members one of another."

This is not to say that all functions are of equal general interest, or that the interest in the satisfactory performance of what was once regarded as strictly local functions does not weaken with distance. Nor is it to say that there are no functions so overwhelmingly of strictly local interest that wider interests can be ignored. Determining degrees of interest in the various services of government are among the difficult tasks in the functional approach to the coordination problem.

The major trends in interdependence are often made the basis of proposals for: increasing the size of political units; centralization of the tax system to reach taxpaying ability better and to reduce extraterritorial shifting; increasing central financial support or equalization of the "general welfare" functions of government, or transfer of functions of wide concern upward among levels of government. Other suggestions are concerned with promotion of uniformity in State tax laws and other laws, and elimination of interstate trade barriers. The National Resources Committee's report on technological trends stated typically:

> All inventions which make it possible for goods to be moved cheaper or more quickly, people to travel faster and more comfortably, or ideas to be better conveyed, in point-to-point or wholesale communication, tend, first, to build up larger, more widespread businesses. These tend to outrun the powers of local regulation and taxation and to become more subject to wider areas of governance.[79]

It may be said with considerable confidence that what we have seen thus far in the way of economic interdependence, overlapping taxes, and problems of fiscal policy is likely to look quite small in comparison with that which lies ahead. There is no reason to believe that present trends will not continue or that the acceleration of pace will subside. On the contrary, the acceleration is likely to increase sharply.

[77] Arthur W. Macmahon, "Taking Stock of Federalism in the United States," The Canadian Journal of Economics and Political Science, vol. 7, May 1941, p. 190.

[78] Sidney Webb, Grants-in-Aid: A Criticism and a Proposal, Longmans, London, rev. ed., 1920, pp. 23-24.

[79] National Resources Committee, Technological Trends and National Policy, June 1937, p. 36.

C. History of the Fiscal Coordination Movement in the United States

1. Development of the Movement [80]

(a) Before and during the First World War.

It is probably proper to accept 1917 as the beginning of the fiscal coordination movement. Of course, on the functional side of the coordination problem and on the wider problems of federalism, there had been much comment and even some action during the nineteenth century. Interstate compacts had been authorized by the Federal Constitution, and this mechanism had been used fairly frequently in disputes among States over boundaries and other similar matters. The Conference on Uniform State Laws, an offspring of the American Bar Association, began its task of framing and promoting certain model statutes for uniform State adoption in 1892. The Conference appointed a committee on uniform taxation in 1902. This organization continued to discuss tax problems and organize tax committees, but did not develop specific contributions in the field of fiscal relations, save for the adoption of a uniform reciprocal transfer act in 1928. Before 1917 an occasional speech or article called attention to the seeds of fiscal incoordination. But it was only after the adoption of the State income tax by Wisconsin in 1911 and by Massachusetts in 1916, and after the entry of the Federal Government into the income- and death-tax fields just preceding and during the First World War, that the matters of coordination and division of the tax field really came to life.

The Federal wartime taxation was the occasion in 1917 for forming and calling a meeting of the National Council of States. This meeting, to which President Wilson indicated no serious Federal objection, was attended by official and unofficial delegates of 44 States. The conference marks the beginning of a tangible organized "movement" for coordination of Federal and State taxation. A committee of the New York State Tax Association which had called attention to the gradual Federal assumption of tax sources developed by the States and had sounded a general warning of the dire consequences to follow, played an important role in the conference.

At the Council meeting, strong statements were made concerning "Federal encroachments on States' rights," "the crisis in State finance," and "conflicts of jurisdiction." Fear was expressed that Federal taxing power might be carried to the point of "exhaustion of national resources" and that the National Government was violating the traditional separation of sources established for more than a century.[81] The Council of States' decision to suspend action for the duration of the war was best expressed in the words of a delegate: "In time of war, Uncle Sam has the right-of-way in taxation. If need be, he can have the whole highway. The States and cities will bump along on the roadside, in the ditches, or build new roads through the fields." [82] It was hoped that the Council of States would continue

[80] Based mainly on a monograph prepared for this study: Russell Hinckley, The Movement for Fiscal Coordination.

[81] Preliminary Report to the Legislature of the Committee of the State of New York upon the Relations of Federal and State Taxation, Albany, N. Y., 1918, p. 6.

[82] Quoted by Rowland Egger, "World War I and State Finance," National Defense and State Finance, Alabama University, Tuscaloosa, 1941, p. 55.

to meet and develop reports and coordination plans, especially in the post-war period in which increasing frictions were visualized. This particular organization, however, did not survive.

(*b*) *During the 'twenties.*

Principal interest in coordination during the 'twenties centered about the efforts of State tax officials and others representing the States to induce the Federal Government to withdraw from the estate-tax field. This death-duties field had long been considered a special State preserve, as indicated by the National Tax Association's position from the date of its first organization. There were some, however, who held the opinion that interstate competition was actually more devastating than Federal encroachment. Resolutions requesting the repeal of the 1916 Federal duties were passed at conferences of the National Tax Association in 1920, 1921, and 1922. In 1924, Congress actually increased estate-tax rates, but at the same time adopted the important provision for crediting State taxes up to 25 percent of the Federal liabilities. The Secretary of the Treasury had opposed the 1924 rate increases and, in signing the bill, President Coolidge proposed a conference of Federal and State tax officials to seek means of apportioning tax sources and of eliminating overlapping and unfair taxes. The National Tax Association organized such a conference which, after a close vote and much argument, adopted a committee proposal for the repeal of the Federal estate tax in 6 years, reduction in rates, and increase in the credit provision to 80 percent.[83] Congress, in 1926, reduced estate-tax rates and increased the credit to 80 percent, but did not provide for repeal. This established the crediting principle, so often cited since as the only example of substantial coordination and so hopefully stressed as a workable precedent for action in other tax fields. The entire episode, however, illustrated the difficulty of obtaining agreement among State tax groups on any proposal. Even the nine members of the special committee of the Conference on Inheritance and Estate Taxation could not agree. Had a constitutional amendment been involved, rather than congressional legislation, it is doubtful whether any action would have been taken.

In 1927, representatives of 40 States attempted to obtain repeal of the estate-tax credit to clear the ground for final elimination of the Federal tax. The Connecticut Tax Commissioner argued for State opposition to "Federal aggressions upon financial control of States;" attacked the failure of the House Ways and Means Committee to consider fairly the merits of the estate-tax credit repeal, and despaired of court action to consider it.[84]

Under the leadership of a special Pennsylvania Tax Commission, a group of State tax commissions launched a movement in 1924 for reciprocity in inheritance taxation as an antidote for multiple taxation. The National Tax Association also lent its support to this movement. Considerable success attended these efforts. A 1932 Supreme Court decision seemed to establish the principle that intangibles were taxable mainly, if not solely, by the State of the domicile of the decedent. This

[83] Proceedings of the Second National Conference on Inheritance and Estate Taxation, at New Orleans, November 10, 1925, under auspices of National Tax Association, 1925, pp. 82, 91.

[84] Report of the Tax Commissioner, State of Connecticut, 1927-28, Hartford, Conn., 1928, p. 40. The Supreme Court had upheld the crediting provision in *Florida* v. *Mellon* (273 U. S. 12 (1927)).

was followed by a relaxation of the movement and the repeal of a number of reciprocity statutes.[85]

Mention might also be made of a proposal of the United States Chamber of Commerce in 1925 for the creation of a Federal-State agency on tax coordination, a proposal which the Chamber and others have continued to advocate. In 1920, at the Annual Conference of State Governors, Governor Sproul of Pennsylvania suggested a Federal-State Commission to develop plans of coordination and protection of State revenues. This is one of a long series of such proposals which have increased in volume up to the present writing. The Connecticut Tax Commissioner in 1928 threw cold water on another favorite coordination proposal. He attacked the theory and practice of basing State revenue laws upon Federal legislation. He concluded from his experience that, basing State corporation income taxes on Federal returns and following Federal admissions' tax practice result in severe administrative difficulty which outweigh any supposed advantages in taxpayer convenience, cost of compliance, and cost of administration. The report concluded: "There is no necessity for dependence of the State upon the action of an outside legislative body with respect to such an important matter as the levying of taxes." [86]

Except for the controversy over estate taxation, the period 1920 to 1929 produced little of significance in the coordination movement. This is explainable by the fact the period was one of prosperity, and that the trend in the level of Federal taxation was downward. However, State tax sources were extended materially.

(c) *Period 1930–41.*

(1) *General trend.*—The period 1930 to 1941 was by far the most active with respect to general calls for coordination, definite proposals, and organized group consideration of the subject. The volume of discussion was so heavy as almost to defy classification. The reasons are obvious: The depression revenue problems of States and local units were acute; the States were increasing rates and exploiting new tax sources; continuous expansion at the Federal level was also occurring from 1932 on. The States were alarmed at the latter development, and the intensity of their alarm increased with each successive revenue act. Business groups generally were not as vocal until 1935 and 1936, when it was realized that, although the depth of the depression had been passed, recovery was not secure, that business taxation would remain at a high level, and that the new Federal and State taxes were not actually of an "emergency" character. The defense emergency introduced a completely new period in Federal finance and stimulated more and more proposals from all sources for national surveys, commissions, and committees on coordination.

Throughout the decade, the evils of overlapping taxation and the need for fiscal coordination have been reiterated by most prominent public figures, including President Hoover, President Roosevelt, Secretaries of the Treasury Ogden Mills and Henry Morgenthau, Jr., Mayor LaGuardia, C. A. Dykstra, Governor Lehman, and many others. Their conceptions of the problem and of the proper approach

[85] Franklin S. Edmonds, "Injustice Through Inheritance Taxation," Illinois Tax Problems, Illinois Tax Commission, 1939, pp. 325–331.

[86] Report of the Tax Commissioner, State of Connecticut, 1927–28, pp. 25–26. However, Connecticut still taxes corporate income by reference to Federal acts.

to its solution varied widely, although there was general agreement on the need for Federal-State conferences and research bodies. Necessarily, specific measures were not usually advocated in addresses on the subject, although "segregation of sources" was frequently mentioned and Mayor LaGuardia outlined a plan based on further use of a modified crediting device.[87]

Individual proposals were made for extension of the crediting plan to particular commodity taxes,[88] sales taxes, corporation taxes,[89] and personal income taxes,[90] and for broadening of the estate-tax credit to include all rates in force instead of merely the 1926 rates.[91] Suggestions were made for State supplements and additions to Federal taxes,[92] Federal administration combined with sharing, grants, or assumption of functions, and segregation of sources in various combinations. One unique proposal would have combined a scheme of separation with a system of Federal requisitions upon the States to meet deficits.[93] Many prominent figures appeared to despair of any satisfactory ultimate solution short of completely centralized taxation.[94]

(2) *Federal activity and the failure of liquor-tax coordination.*—Although the coordination movement has always received most of its drive from State officials, the period under consideration witnessed a very considerable amount of Federal interest and activity. Throughout the period, a series of proposals was made in Congress to authorize various types of State taxation of interstate business. Illustrative of this effort were the Harrison and Lea bills [95] to authorize nondiscriminatory sales taxes on transactions arising in interstate commerce and a bill to permit States to apply the same measures of taxation to interstate commerce as were applied to the same elements of internal commerce.[96]

In July 1932, the staff of the Joint Committee on Internal Revenue Taxation commenced its study of "double taxation" as authorized by a special subcommittee of the House Ways and Means Committee. Its report, Double Taxation, issued in January 1933, was chiefly factual, describing taxes in force, and pointing out some 326 cases of duplicate or double taxation between Federal and State Governments. No plan of coordination or discussion of methods and issues was presented in this report, although it is significant as the first attempt of the sort at the Federal level.[97] The joint committee issued other factual reports describing (1) the legal status of State and Federal taxing powers under the Constitution and court decisions and (2) the joint

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[87] Fiorello H. LaGuardia, "Financing Urban Government Today," (2), Illinois Tax Problems, Illinois Tax Commission, 1939, pp. 69, 70, 77.

[88] North Carolina Legislature's proposal for commodity tax credits, particularly tobacco; E. M. Perkins, "System of Federal Credits for Taxes Paid to States," North Carolina Law Review, February 1932.

[89] H. R. 12643 (Connor), 72d Cong., 1st sess., June 15, 1932; John J. Merrill, New York State Tax Commissioner (1932).

[90] Mark Graves, "Hand in Glove," State Government, January 1932, pp. 12-13.

[91] New York State Commission for the Revision of the Tax Laws, Report, Legis. Doc. (1932), No. 77, Albany, 1932, p. 22.

[92] E. R. A. Seligman, "The Fiscal Outlook and the Coordination of Public Revenues," Current Problems in Public Finance, Commerce Clearing House, Chicago, 1933, p. 273.

[93] Henry F. Long, Proceedings of the National Tax Association, 1932, p. 258.

[94] S. E. Leland, "The Relations of Federal, State, and Local Finance," Proceedings of the National Tax Association, 1930, p. 96; R. M. Haig, "The Relation of the Tax Systems of the State and Nation," Lectures on Taxation, Commerce Clearing House, N. Y. 1932, p. 250.

[95] S. 994, 74th Cong., 1st sess., January 15, 1935 (Senator Harrison); H. R. 3971, 74th Cong., 1st sess., January 14, 1935 (Representative Lea).

[96] S. 3074, 72d Cong., 1st sess.

[97] Double Taxation, Preliminary Report of a Subcommittee of the Committee on Ways and Means Relative to Federal and State Taxation and Duplications Therein (1933). In 1935, L. H. Parker of the joint committee staff stated: "* * * The staff of the joint committee is in a position to publish promptly a revised and up-to-date report on double taxation when the opportune time arrives." ("Congressional Study of Conflicting Taxation," Taxes, May 1935, p. 264.)

use of death taxes by the two levels of government The committee staff also participated in a number of discussions with representatives of State groups on the general problem of coordination and on coordination of specific taxes, notably liquor and gasoline taxes.

In 1933 and 1934, following repeal of the prohibition amendment, an opportunity was presented to work out a coordinated plan of liquor taxation, since no taxes were in force and dual impositions upon an important source of tax revenue were imminent. An informal interdepartmental committee recommended to the Secretary of the Treasury a plan for exclusive Federal administration of gallonage taxes, the proceeds to be shared with States not imposing such taxes, according to a formula somewhat weighted in favor of producing States.[98]

The Interstate Commission on Conflicting Taxation submitted its plan for Federal gallonage taxes and a general, equal sharing of the proceeds of all taxes and licenses (Federal, State, and local) attributed to sale of liquor within the State.[99] This plan, based on consumption, did not favor producing States. In the congressional hearings, no agreement was evident on any plan of sharing which did not give weight to production. The dry States also opposed distribution solely to wet areas as proposed by both the interdepartmental committee and the Interstate Commission on Conflicting Taxation. Accordingly, no plan of coordination was adopted and the opportunity was missed. The sentiment for coordination probably resulted in somewhat lower Federal gallonage taxes than would otherwise have been imposed.

In 1934, the Treasury Department commenced a number of lines of investigation of foreign and domestic Federal, State, and local tax systems and was specifically directed by the President in 1935—

> to undertake a study of the sources of taxation, with particular reference to the matter of conflict or overlapping of Federal, State, and local taxation * * *. When this study is complete, it should furnish the basis for discussion of the problem involved with representatives of the States.[1]

The published report was a compilation of tax yields from eight sources of taxation used by both Federal and State governments.[2] Other investigations are in the form of confidential Treasury memoranda.

In 1935, the President, addressing the Conference of Mayors, announced his intention to call a conference in 1936 to work out a plan of revision and coordination of Federal, State, and local tax systems. This particular conference was not called, although several resolutions in Congress during 1937 urged it.

In May 1937, Senator Davis of Pennsylvania introduced a resolution for a national tax commission of three members to make a continuous study of the Federal and State tax structures. In May 1938, Representative Treadway of Massachusetts also proposed the creation of a Federal tax commission to study tax coordination. The proposal by Mr. Treadway was repeated in 1939 and discussed in correspondence with the Secretary of the Treasury. A commission of 10 members (4 Congressmen and 6 representatives of various groups) was suggested.[3] Other similar proposals have been made in Congress.

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98 Generally similar suggestions were made privately in the Rockefeller Report: R. B. Fosdick and A. L. Scott, Toward Liquor Control, New York, 1933, and by Paul Studenski, Taxation of Liquor, Citizens' Committee for Sane Liquor Laws, New York, 1934.

99 Clarence Heer, "Splitting the Liquor Taxes," State Government, December 1933, pp. 15-17.

1 Cited by Roswell Magill, "The Coordination of State and Federal Taxes," Taxes, April 1937, p. 190.

2 U. S. Treasury, Collections from Selected State Imposed Taxes, 1930-36, Division of Research and Statistics, November 30, 1936.

3 Congressional Record, 77th Cong., 3d sess., vol. 86, pt. 4, April 10, 1940, p. 4291.

At the hearings on the 1939 Revenue Act before the House Ways and Means Committee, Secretary Morgenthau presented the Treasury's suggestion that Congress create a small temporary national commission to report on intergovernmental fiscal policy and to prepare a plan for solution of the problems involved.[4]

In his budget message on January 8, 1941, President Roosevelt again stated his long-standing interest in the coordination problem. The President had expressed his concern from the State standpoint while Governor of New York, and as President he dealt with the subject in a number of statements to the Interstate Legislative Assemblies and other conferences of State and local officials; and in his budget message of January 8, 1941, he said:

> We must face the fact that the continued maintenance of an expanded Army and Navy and the interest on our defense debt will call for large Federal expenditures in the years ahead. Our tax system must be made ready to meet these requirements. I am as much concerned about our long-run need for an improved tax system as I am about the immediate necessity of financing the defense program. I have often expressed my belief that no really satisfactory tax reform can be achieved without readjusting the Federal-State-local fiscal relationship. I urge a thorough investigation of the possibility of a comprehensive tax reform.[5]

(3) *Activities of the "Chicago group" of interstate organizations.*—In September 1932, the American Legislators' Association at its annual meeting discussed problems of conflicting taxation and in December it proposed the First Interstate Legislative Assembly. Governor Roosevelt of New York endorsed the plan, and the meeting was held in Washington in February 1933. Creation of the Interstate Commission on Conflicting Taxation was authorized. In April 1933 the Commission conferred with representatives of congressional committees and Treasury officials at the first significant Federal-State meeting on the subject of revenue coordination. The Senate Finance Committee endorsed the Interstate Commission's recommendation that the Federal gasoline tax be repealed by June 30, 1934, and authorized appointment of a subcommittee to join with the House subcommittee and State representatives to propose plans for elimination of tax conflicts.[6]

By far the most exhaustive research on the subject of Federal-State fiscal relations was that carried on by the Interstate Commission on Conflicting Taxation. Its report of 1935 was particularly comprehensive and able. The details of the program worked out and supported by the Commission are presented below.[7]

The Second Interstate Assembly in 1933, adopted a resolution approving the Interstate Commission's plan for a tax-revision council, to be comprised of Federal, State, and local representatives.

The Tax Revision Council was promptly established with eight representatives from each level of government. The council was directed to study the proper allocation of functions and the problems of multiple taxation by competing units of government. At the first meeting in June 1935, Secretary of the Treasury Morgenthau (the first chairman) pointed out that justice to the taxpayer should be the basic objective. Five committees were appointed. No substantial progress has been made by this body, and no reports have been issued.

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[4] Ibid.
[5] Cited in: "Billions for Defense," Annals of the American Academy of Political and Social Science, March 1941, p. 6.
[6] "A Log," State Government, vol. 6, No. 7, July 1933, p. 1.
[7] Council of State Governments, Book of the States, 1935, pp. 425-26, 433 and 441.

The Council of State Governments offered $25,000 for the work, but no matching Federal funds were provided, despite requests to the Appropriations Committee of the House of Representatives.[8] The disappointing results of 4 years of effort and the establishment of such elaborate organization were sadly reported in a quotation in the Book of the States for 1937.

> * * * with taxes mounting, with record State budgets piling heavier loads on selected tax goats, with cities clamoring for more taxing power, with emergency taxes riveted into permanence, we are still in the committee stage of reports, restating of the tax problem, headshakings over difficulties. Will 1950 find a self-governing people staggering under worse multiplied tax burdens, still only listening to reports about it and wishing somebody would do something?[9]

In 1934 the National Association of Tax Administrators was organized with the main object of obtaining congressional action on the Harrison bill (S. 994, 74th Cong.) to permit States to impose nondiscriminatory sales taxes on transactions in interstate commerce. The Association disapproved of a Federal sales tax as a method of eliminating the discriminations in favor of interstate sales. This group consisted mainly of representatives of sales tax States who were dissatisfied with the failure of the National Tax Association to endorse the Harrison bill. The latter had also been endorsed by the Interstate Commission on Conflicting Taxation. As the National Association of Tax Administrators has grown in scope, its interest in coordination has continued, and it has sponsored several committees on coordination problems.

The Special Committee on Taxation of the Council of State Governments had consulted with the Treasury in 1940 concerning the latter's recommendation for a National Tax Commission. It also arranged to meet again with Senate and House committees in 1941. The Fifth General Assembly of the Council of State Governments in January 1941 endorsed by resolution the recommendation for a National Tax Commission.[10]

In 1942 the Municipal Finance Officers Association published a report on Federal-State-local fiscal relations prepared by Thomas H. Reed.[11] The report approached the problem from the municipal point of view and called attention sharply to the fact that returns from real-estate taxation are suffering "from the effects of blight on real-estate values and the severity of Federal taxation, as well as from bad assessing practices and tax limitation." Federal and State assistance (especially Work Projects Administration) were criticized on the ground of inequality and uncertainty and because they stimulated local expenditure rather than relieved local tax burdens.

(4) *The National Tax Association and the Graves-Edmonds plan.*—The National Tax Association has always taken a lively interest in the coordination problem and it was quite as active in this field during the thirties as it had been during the twenties.

At the twenty-sixth Conference of the National Tax Association in 1933, a committee on fiscal relationships of Federal and State governments was appointed under the chairmanship of Henry H. Bond. Certain alternative coordination devices were outlined and the efforts of other groups recounted in its preliminary reports in 1934 and 1935.

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[8] Council of State Governments, Book of the States, 1937, p. 8.
[9] Ibid., p. 83.
[10] General Assembly Resolutions, State Government, vol. 14, No. 3, March 1941, p. 70.
[11] Thomas H. Reed, Federal-State-Local Fiscal Relations, Municipal Finance Officers Association, Chicago, 1942.

The membership of the committee changed in 1935, and no final committee report could be agreed upon in 1936.[12] Each member proceeded to present his own views. A marked cleavage developed between the opinions of Chairman Bond and Henry F. Long on one side and Mark Graves and F. S. Edmonds on the other. The basis for argument was the Graves-Edmonds plan, which had been presented in the committee's report, and which received sufficient attention in this period to be regarded as a substantial landmark in the coordination movement. The Graves-Edmonds plan was designed to relieve real estate, to reduce the complexity of State tax laws, and to minimize the costs of collection and compliance. It suggested Federal administration of certain major taxes then subject to dual administration, with distribution to the States on an "equitable basis." Specifically, the plan provided for Federal collection and distribution of liquor, gasoline, and cigarette taxes and a general manufacturers' excise tax to be adopted in lieu of the existing excises.[13]

In defense of the plan, Senator Edmonds pointed out that it was developed in view of extraordinary revenue needs of State and local welfare and educational services and in the hope that States and localities might retain their functions without soliciting Federal grants. Chairman Bond and Mr. Long stressed the extreme danger to State sovereignty in such plans of centralization.[14] The chairman concluded: "The matter under consideration is obviously one upon which there can be no general agreement at this time. * * * I feel that there is no further advantage in the continuance of the committee and that it is not a matter upon which the Association ought to take any action by way of resolution."[15]

In 1939 the final report of the National Tax Association Committee on Federal Taxation of Corporations (Robert Murray Haig, chairman) pointed out the difficulty of developing a suitable plan of corporate taxation in the face of uncoordinated Federal and State tax systems. It endorsed Secretary Morgenthau's recommendation before the House Ways and Means Committee on May 27, 1939, that a small temporary national commission be established to report to Congress on various aspects of intergovernmental fiscal policy.[16] The report and its discussion covered many important aspects of the coordination problem and brought out again the divergent viewpoints on Federal versus State administration. The report pointed out a number of considerations favoring exclusive Federal taxation of personal incomes as a prerequisite to proper corporate taxation.

In 1940 the National Tax Association, after a challenge to its conference by Governor Lehman, again authorized a Committee on the coordination of Federal, State, and local taxes. The Governor had pointed out the virtual preemption of many tax fields by the Federal Government and the discouragement of initiative and enterprise as a result of duplication. He called for a committee representing both the three levels of government and independent tax experts

[12] Report of Committee of the National Tax Association on Fiscal Relationships of Federal and State Governments, Proceedings of the National Tax Association, 1936, pp. 254-266.
[13] Report of Committee of National Tax Association on Fiscal Relationships of Federal and State Governments, Proceedings of the National Tax Association, 1934, p. 166.
[14] Proceedings of the National Tax Association, 1936, pp. 255, 257.
[15] Ibid., p. 257.
[16] Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations, Proceedings of the National Tax Association, 1939, pp. 534-581.

to endeavor to bring order out of chaos in intergovernmental fiscal relations.[17] The National Tax Association committee was formed and it held a joint meeting in February 1941, with the similar committee of the section on taxation of the American Bar Association. Henry F. Long, Massachusetts Commissioner of Corporations and Taxation, was named chairman of both of these committees as well as of the similar committee of the National Association of Tax Administrators and a joint committee of all three groups.

(5) *The Canadian Royal Commission.*—A number of individual studies of foreign experience with intergovernmental fiscal relations were made in this period,[18] and cited in connection with proposals for solution of the American problem. But by all odds the most important interest in foreign developments attended the report of the Canadian Royal Commission on Dominion-Provincial Relations. This was a comprehensive attempt to solve the over-all problems of readjusting intergovernmental fiscal relations in a federal state, and it undoubtedly stimulated many of the proposals for the creation of a similar body in the United States. The Royal Commission endeavored to steer a course between centralization and decentralization, probably considerably closer to the former than the latter. Its bold and specific attack stirred considerable political dispute in Canada, and one attempt to convert the plan into action proved abortive. Nevertheless, the report must be acknowledged as the most notable effort of its kind, and some of the changes recommended have been realized during the war period.[19]

(6) *Other events of the 'thirties: Progress on functional side of coordination.*—In the field of interstate cooperation, the Council of State Governments, since 1935, has organized commissions on interstate cooperation in most States with membership consisting of legislators and administrative officers. These commissions have stressed the need for reciprocal tax laws to promote uniform and nondiscriminatory taxation, particularly in the insurance, personal income, and inheritance tax fields. Also urged are reciprocal agreements between State officials for inspection of tax returns and cooperation in adoption of reciprocal administrative and legislative regulations for exchange of information on interstate shipments, etc. Interstate compacts were generally regarded as not adaptable to the tax field, except possibly as the basis for negotiation between the States and the Federal Government for elimination of duplicate levies or arrangements for single collection of taxes.[20]

A regional tax committee on interstate cooperation representing eastern State commissions has continued to work on the interstate problems of estate taxation and the development of reciprocal legislation providing for proration of collections, or compromise or arbitration of differences.[21] The New York and Pennsylvania subcommittees were most active in the work of promoting exchange of tax information and eliminating certain instances of double taxation.

In 1939 a national conference on interstate trade barriers was held by the commissions on interstate cooperation. This was part of a

[17] Proceedings of the National Tax Association, 1940, pp. 177-182.

[18] See Mabel Newcomer, Central and Local Finances in Germany and England, Columbia University Press, New York, 1937; Robert Murray Haig, "Amalgamation of Federal-State Tax Administration in Australia," Proceedings of the National Tax Association, 1937, pp. 371-379.

[19] Report of the Royal Commission on Dominion-Provincial Relations, 1940.

[20] Report of Regional Committee on Conflicting Taxation, Council of State Governments, 1938 (26 pp. mimeographed).

[21] Council of State Governments, Book of the States, 1941-42, p. 20.

widespread movement, involving many agencies, including the Department of Agriculture and the Temporary National Economic Committee. Some influence was exerted by the interstate commissions in preventing further trade-barrier legislation and in obtaining repeal of existing laws.

The Federation of Tax Administrators and its associated organizations were an important development in the slow process of interstate cooperation through reciprocal administrative relations. These affiliates include the American Association of Motor Vehicle Administrators, the National Association of Assessing Officers, the North American Gasoline Tax Conference, the National Conference of State Liquor Tax Administrators, the National Association of Tax Administrators, and the National Tobacco Tax Conference. Strong pressure for uniform laws, reporting forms and tax procedure by organizations in the petroleum and other industries and by the American Automobile Association was instrumental in this development.

While progress on the institutional side of the coordination problem during the 'thirties was very small compared with the volume of effort, very real, not to say revolutionary, changes were taking place on the functional side. In response to the depression, the Federal Government undertook a large array of new functions, ranging from social security to housing. Grants-in-aid were very greatly expanded, though without sufficient attention to the logic and effects of the system established. The Supreme Court, after invalidating some considerable portion of the New Deal program, turned about in the later 'thirties and accepted much of the program, thereby establishing a precedent for a more flexible interpretation of the Constitution and underwriting a broader scope for Federal powers. On the other hand, the Court also reopened opportunities for two or more States to tax the same assets, particularly through their inheritance-tax laws.[22]

2. SPECIFIC COORDINATION PLANS

By far the most ambitious of the many coordination plans are those proposed by the Interstate Commission on Conflicting Taxation, by Commissioner Graves and Senator Edmonds, and by the Canadian Royal Commission. The plans will now be presented in some detail.

(a) *Plan of the Interstate Commission on Conflicting Taxation.*

In its first report, the Interstate Commission recommended that (1) the Federal Government retire from gasoline taxation by June 30, 1934; (2) no additional tobacco taxes be levied by States; (3) electrical energy taxes be left to the States; (4) States and localities refrain from heavy beer taxation, except for regulation. It proposed to study general sales taxation and suggested a conference concerning the use of compacts for State tax problems not amenable to solution by other forms of cooperation.[23]

The commission then developed its plan of liquor taxation, proposing a Federal tax on spirits of $3 per gallon, and proportionately lower taxes on other alcoholic beverages. A plan of distribution was worked out whereby one-half of all liquor revenues (Federal, State, and local) raised in a given State would accrue to the State. This

[22] J. R. Hellerstein and E. B. Hennefeld, "State Taxation in a National Economy," Harvard Law Review, April 1941, pp. 949–976.

[23] "Recommendations," State Government, July 1933, p. 3.

plan was presented before congressional committees considering new legislation on liquor taxation. In sales taxation, the commission favored the Harrison bill to authorize nondiscriminatory State taxation of interstate sales by the State into which the tangible property is moved for use or consumption. The commission also favored a general enabling act for interstate compacts and proposed that the President appoint a commission to consider the coordination of revenue systems and the allocation of functions of government. This latter suggestion developed into its later proposal for a tax revision council of Federal, State, and local officials.[24]

In 1935 a plan of differential Federal credits for State income taxes was suggested; generous credits were to be allowed in the case of taxes on small incomes and lesser credits for taxes on the large incomes. Additional Federal revenues required could be derived from: Inclusion of all dividend income in the Federal base; constitutional amendment to permit taxation of all governmental salaries and income from public securities; reduction of personal exemptions and elimination of the earned-income credit; allowance of personal exemption and credits for dependents in terms of tax.[25]

The Interstate Commission then completed its exhaustive report, Conflicting Taxation, issued in 1935, presenting in addition to the, above recommendations, three general plans for eliminating tax conflict. The first embraced extreme centralization with exclusive administration by the Federal Government of death taxes, personal and corporation income taxes, and all sales taxes, including tobacco, liquor, and gasoline taxes. The second plan, calling for moderate centralization, provided credits for income and death taxes, and Federal administration of liquor, tobacco, and gasoline taxes, with distribution of proceeds according to the presumed origin of collection. All other taxes were to be subject to segregation. The third plan involved a minimum of centralization, depending chiefly on segregation and intergovernmental comity. Various combinations of elements of the three plans, if opportunism were to be the basis of procedure, were also visualized.[26] The plans were outlined in fairly complete detail and represent one of the most significant attempts of the decade to treat the problem.

Under the plan of extreme centralization, the States might share in proceeds of Federally administered individual and corporate income taxes, death taxes, general sales taxes, and the liquor tax through (1) distribution based on origin or geographic source of funds; (2) subsidies for general purposes on a population basis, or other basis of need; (3) subsidies for particular functions with prescribed standards of performance. Federal assumption of functions might also be attempted. The tobacco tax might be shared according to the Doughton resolution proposal.[27] A 4-cent Federal gasoline tax might be distributed—3 cents directly to States according to motor-vehicle registrations and 1 cent as an equalization fund to obviate the need for additional State taxes.

[24] Report of Interstate Commission to the Second Interstate Assembly, American Legislators' Association, Chicago, 1935.

[25] Interstate Commission on Conflicting Taxation, Conflicting Taxation, American Legislators' Association, Chicago, 1935.

[26] Ibid., pp. 183–185. The Commission also prepared a number of special tax studies and participated in consideration of Federal tax measures of the period, urging its recommendations before congressional committees with no success.

[27] H. J. Res. 546, 72d Cong., 2d sess., January 10, 1933, proposed distribution of cigarette tax revenue (one-sixth of collections) to States according to population provided States did not impose any taxes on cigarettes or any prohibition on manufacture or sale. The proposal was offered in the interest of coordination and protection of the Federal yield from State taxation measures.

The moderate centralization plan was developed as follows:

(1) *Individual income tax.*—Federal credit for State taxes up to a specified proportion of the amount payable under the Federal tax, subject to congressional action to avoid interstate conflicts, particularly double taxation; assessment and collection of supplementary State taxes by the Federal Government if the State so wishes and if it accepts the Federal definition of income.

(2) *Corporation income tax.*—A similar credit limited to a specified percentage of such proportion of the Federal tax as the income allocated to the State bears to the total income of the corporation, subject to congressional regulation to avoid interstate conflicts, particularly double taxation; Federal collection of State taxes at the option of the State, if the Federal definition of income is accepted.

(3) *General sales taxes.*—State compacts to achieve uniform definitions and regulations and repeal of conflicting Federal manufacturers' excise taxes.

(4) *Tobacco tax.*—Reserved for exclusive use of the Federal Government.

(5) *Death taxes.*—Adjustment of crediting provision to apply to the total amount of the Federal tax, including the so-called additional estate tax; provision for Federal administration and State supplements.

(6) *Liquor taxes.*—The field to be divided between the Federal and State Governments, according to a previous Commission recommendation for Federal collection of all gallonage taxes, State and local collections of licenses and other taxes, and a modified sharing plan. Approximately one-half of gross revenues derived by Federal, State, and local governments from all liquor tax sources to accrue to the States.

(7) *Gasoline tax.*—Federal tax of 3 cents distributed to States according to motor-vehicle registrations; States permitted to impose additional taxes if desired.

Under this plan the States would still have the right to tax the entire income of residents from sources within or outside of the State, and income originating in the State but accruing to nonresidents. To avoid double taxation, Congress might provide that States qualify for the credit only if they allow income taxes paid by their residents to other States on personal income arising in the latter to be offset against their own taxes in the proportion of income so taxed to total income.

The third plan, one of minimum centralization, provided:

(1) *Individual income tax.*—Reservation of incomes under $10,000 for State taxation; incomes over $10,000 to be taxed by both Federal and State Governments; assessment and collection of State taxes on incomes over $10,000 by the Federal Government if the State so desires and if it accepts the Federal definition of income.

(2) *Corporation income taxes.*—Similar to above; Federal assessment and collection, if the State accepts the Federal definition of income and the prescribed basis of apportioning interstate income.

(3) *Death taxes.*—Adjustment of the 80 percent credit principle to apply to total Federal tax, and provision for central administration and State supplements.

(4) *General sales taxes.*—Voluntary development of uniform definitions and regulations.

(5) *Tobacco taxes.*—Reserved for exclusive use of the Federal Government.

(6) *Gasoline tax.*—Exclusively reserved for State and local use.

(7) *Liquor tax.*—Gallonage taxes reserved for Federal use, licenses for State and local use.

Promotion of Federal-State and interstate agreements was held to be essential to the third plan. To effect the division of revenue sources, Federal legislation was suggested exempting incomes under $10,000 and providing for repeal of the gasoline tax to take effect if a sufficient number of States passed laws agreeing not to impose tobacco and liquor-gallonage taxes. The minimum centralization plan particularly required promotion of interstate agreements and, if necessary, formal compacts to bring about interstate uniformity in tax jurisdiction and allocation formulas.

A combination of all three plans might involve, for example: extending the crediting plan to personal income taxes; Federal administration and sharing of corporation income taxes; an application of the 80-percent credit provision to the total amount of the Federal estate tax with specific provision for Federal administration of the amount subject to credit plus possible supplementary levies, both at the discretion of the States; Federal excise taxes and State licenses in lieu of present liquor taxation; redistribution of other excises between Federal and State Governments with reservation of tobacco taxes to Federal use, and gasoline taxes to the States.[28]

(*b*) *The Graves-Edmonds plan.*

As previously stated, the Graves-Edmonds plan provided for Federal collection of liquor, gasoline, and cigarette taxes, and a general manufacturers' excise tax to be adopted in lieu of existing excises.

According to the plan, part of the proceeds of a basic Federal liquor tax of $3 per gallon was to be distributed to States according to an allocation fraction. A Federal per capita figure was to be derived from the ratio of total Federal liquor-tax collections to total population of wet areas. A State per capita figure was to be derived from the ratio of total State and local liquor licenses and taxes to the population of wet areas of the State. If the State per capita figure were less than one-half of the sum of State and Federal per capita figures, the difference was to be multiplied by the population of the wet areas of the State, thereby deriving the amount to be paid by the Federal Government to the State. The liquor-tax proposal was substantially that of the Interstate Commission on Conflicting Taxation in 1933.

A Federal gasoline tax of 4 cents a gallon was to be levied, 3½ cents of which was to be distributed to those States agreeing to reduce their gasoline taxes by the same amount and to repeal their taxes outright in 5 years. One-third was to be distributed according to population, one-third according to motor-vehicle registration, and one-third according to improved road mileage.

One cent of the 6-cent Federal rate on cigarettes was to be distributed on a population basis to those States permitting the sale of cigarettes, upon agreement not to tax cigarettes.[29]

Upon enactment of a 5 percent manufacturers' excise tax on all articles except food, 80 percent was to be distributed to the States agreeing not to tax sales in any manner. Funds were to be allocated,

[28] Conflicting Taxation, pp. 183-184.

[29] Following the Doughton resolution mentioned above.

one-half according to population and one-half according to assessed valuation of property as adjusted by the Census Bureau.[30]

(c) *The plan of the Royal Commission on Dominion-Provincial Relations*[31]

The plan of the Royal Commission, while designed for the Canadian federal system rather than that of the United States, contained much that might be equally applicable to the latter. The report offered two plans, though strong endorsement was given the first of these. Plan I recommended:

(1) Provincial withdrawal from the income-tax field (except for those social insurance charges in Provincial jurisdiction) and withdrawal as well from corporation taxes and inheritance and succession duties.

(2) A rebate to Provinces of mining and petroleum taxes equal to 10 percent of profits from the extraction and refining of native mineral products.

(3) Dominion assumption of all dead-weight Provincial debt and all responsibility for unemployed employables.

(4) Abolition of all subsidies and conditional grants (except for the noncontributory grants for old-age pension and small stimulating grants) and the development of a system of national adjustment grants. The national adjustment grants would be supplied to enable Provinces to provide national average standards of educational, welfare, and development and conservation services without greater-than-average taxation. The Provinces would be left free to determine what services would be actually rendered and in what combination, and whether the funds should be applied to raising the level of services or to tax reduction. In determining amounts required to meet average standards, per capita Provincial and municipal expenditures for welfare and education and for highway and other Provincial developmental and conservation services would be compared with the national average, the 1928–31 annual average expenditures being considered normal.

(5) Dominion assumption of all assistance to primary industry.

(6) Dominion assumption of all contributory old-age pension systems.

(7) Regular Dominion-Provincial conferences on intergovernmental relations.

Plan I was most strongly advocated as a means to avoid further temporizing. Plan II would leave intact the prevailing system of Dominion-Provincial financial relations, save for Dominion assumption of responsibility for the care of unemployed employables.[31]

[30] Report of Committee of National Tax Association on Fiscal Relationships of Federal and State Governments, Proceedings of the National Tax Association, 1934, pp. 161–171.

[31] Report of the Royal Commission on Dominion-Provincial Relations, Book II, Recommendations, Ottawa, 1940, pp. 121, 128, 269–271, 274–276.

3. GROUPS INTERESTED IN FISCAL COORDINATION AND THEIR ATTITUDES

A complete list of the organizations actively interested in the coordination movement in recent years would be extensive indeed, but the following partial tabulation is indicative of its scope:

FEDERAL

(1) Bureau of the Budget.
(2) Federal Real Estate Board.
(3) Board of Governors of the Federal Reserve System.
(4) Federal Security Agency.
(5) Federal Works Agency.
(6) House Ways and Means Committee and special subcommittees.
(7) Joint Committee on Internal Revenue Taxation.
(8) National Resources Planning Board.
(9) Senate Finance Committee and special subcommittees.
(10) Temporary National Economic Committee.
(11) Treasury Department—its Division of Tax Research and special Committee on Intergovernmental Fiscal Relations.
(12) Special committees, such as the Advisory Committee on Education.

STATE, LOCAL, AND PRIVATE

(1) American Automobile Association.
(2) American Bankers Association.
(3) American Bar Association—section on taxation.
(4) American Economic Association.
(5) American Federation of Investors.
(6) American Institute of Accountants.
(7) American Legislators' Association—Council of State Governments:
Governors' Conference, Interstate Commission on Conflicting Taxation, Interstate Legislative Assembly, Tax Revision Council, Interstate Cooperation Commissions, and special committees on taxation.
(8) American Management Association.
(9) American Municipal Association.
(10) Farm Bureau Federation.
(11) Federation of Tax Administrators:
American Association of Motor Vehicle Administrators, North American Gasoline Tax Conference, National Conference of State Liquor Tax Administrators, National Tobacco Tax Conference.
(12) National Association of Assessing Officers.
(13) Institute of Public Administration.
(14) International City Managers' Association.
(15) Investment Bankers Association.
(16) Municipal Finance Officers Association.
(17) National Association of Real Estate Boards.
(18) National Association of Tax Administrators.
(19) National Bureau of Economic Research.
(20) National Education Association.
(21) National Industrial Conference Board.
(22) National Highway Users Conference.
(23) National Municipal League.
(24) National Tax Association.
(25) New England State Tax Officials' Association.
(26) Social Science Research Council.
(27) State tax commissions (especially New York) and various special State commissions of research and tax revision.
(28) Tax Institute (Tax Policy League).
(29) Tax Research Foundation.
(30) Twentieth Century Fund.
(31) United States Chamber of Commerce, State chambers of commerce, and National Association of Commercial Organization Secretaries.
(32) United States Conference of Mayors.

Only a few of these organizations can be said to have taken a definite position on the subject of coordination, but a few attitudes and special activities in addition to those already described can be stated.

In 1934 the American Management Association gave attention to the coordination problem through a committee chiefly concerned with the costs of compliance by taxpayers. It generally endorsed the approach of the Graves-Edmonds plan for its advantages in reduction of taxpayers' costs of compliance, recommended a Federal sales tax,[32] and favored centralized administration and sharing of most business income, excise, and sales taxes.[33] The American Federation of Investors also engaged in various studies of the costs of tax compliance in this period.

The United States Chamber of Commerce, however, was somewhat more concerned with "Federal encroachment" on State sources of revenue in the estate, gift, excise, and income tax fields; with undue burdens on the same source by different jurisdictions; and with the tendency of Federal aid to cause large increases in State expenditures.[34] The estate, inheritance, and gift-tax field was deemed to be properly one for State use.

The taxation committee of the National Association of Commercial Organization Secretaries was also concerned with expansion of the Federal Government into local affairs and demanded a simplification and curtailment of the grant and subsidy program.[35] The New York State Chamber of Commerce issued reports on Federal encroachment, yet some other State chambers and their members were more inclined to the centralization view of the American Management Association.[36]

The position of the American Management Association might be said to be characteristic of a large segment of executive opinion. For example, Fortune, an important business periodical, was advocating in 1937 complete centralization of collection of all sources of State revenue in which the States conflict with each other and with the Federal Government. Sharing of collections with the States, without restriction as to use, was suggested.[37]

In 1941, the National Industrial Conference Board presented W. J. Shultz's plan for (1) exclusive Federal collection of commodity taxes and general sales taxes (if enacted) and sharing with the States; (2) division of the field of personal and corporation income taxation and capital stock and estate taxation between State and Federal Governments, the States to levy upon small returns, the Federal Government upon large returns. The States would also be permitted a share of the yield of the Federal taxes on large returns and the privilege of adding their own supplemental corporation and estate tax rates for Federal collection.[38]

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[32] Leading to Senator Barbour's 1934 resolution for study of a Federal manufacturers' sales tax to be distributed to States not imposing sales taxes.

[33] "Discussion of Report of Committee on Fiscal Relationships," Proceedings of the National Tax Association, 1934, pp. 186-187; R. M. Haig, "The Cost to Business Concerns of Compliance With Tax Laws." American Management Association, New York, 1935.

[34] United States Chamber of Commerce, Federal Revenue Legislation, December 1939; Referendum No. 70, Federal Taxes and Expenditures, December 11, 1935. The chamber is giving research staff attention to the subject of fiscal coordination concurrently with the Bar Association and the many others which resumed activity in the field in 1940-41.

[35] National Association of Commercial Organization Secretaries, Proceedings, Twenty-fourth Annual Meeting, 1938.

[36] J. H. Cohen, Increasing Federal Encroachments Upon Powers and Properties of States, New York State Chamber of Commerce, New York, 1938.

[37] "United States Taxes," Fortune, December 1937, p. 200.

[38] National Industrial Conference Board, Essential Facts for Fiscal Policy, New York, 1941, pp. 129-130.

Also illustrative of the business viewpoint in this period was the plan offered by A. R. Kaiser, manager of the tax department of Sears, Roebuck & Co. Concerned with the cost of compliance, Mr. Kaiser suggested Federal administration of all income taxes, with distribution of a portion of the proceeds to States according to an allocation formula averaging several factors. The Federal Government would also administer a single sales tax and distribute all proceeds to the States. Independent State sources would be gasoline and motor-vehicle taxes, occupational licenses, the property tax, and a single tax on business capital employed in the State. Federal sources would include income tax, and all other excises and customs, estate and inheritance taxes, social-security taxes, and, if possible, severance taxes.[39]

4. INDIVIDUAL ATTITUDES

(a) A summary of opinions of public finance professors.

Attention has already been called to the conflict of opinion concerning coordination problems. It may be of interest here to reproduce a summary of the answers to a questionnaire sent to university professors of public finance regarding some of the major proposals in the realm of intergovernmental fiscal relations. Although such polls are subject to many limitations, the answers do show a wide disagreement among the scholars in the field.

	Yes	No	Qualified
All future Federal, State, and local securities issued fully taxable as to income?	109	10	8
All taxation of liquor, imported and manufactured, by the Federal Government?	99	22	6
The present distribution of governmental powers between Federal Government and States be maintained?	34	70	23
Considerable transfer of governmental powers from States to Federal Government?	39	62	26
Slight transfer of governmental powers from States to Federal Government?	54	39	34
Federal Constitution changed to increase Federal taxing powers at expense of States?	40	69	18

[39] A. R. Kaiser, "Tax Reform and Related Improvements Needed in Illinois," Illinois Tax Problems, special report No. 5, Illinois Tax Commission, 1939, pp. 291–295. Other views may be cited briefly.

In 1938, a report of the National Resources Committee concluded: "The whole problem of the division of costs of public works is so complicated by the chaotic conditions of State and local finance and by the perpetuation of undesirable tendencies in the field of intergovernmental fiscal relationships, that it is recommended that the National Government undertake without delay a comprehensive and long-term inquiry into Federal, State, and local finance, both to improve conditions in this field and to develop a better coordinated fiscal system." (National Resources Committee, Division of Costs and Responsibility for Public Works, 1938, p. 106.) The National Resources Planning Board has continued its interest in fiscal coordination from the standpoint of public works planning.

In 1937, the Twentieth Century Fund study generally reviewed the coordination problem, the issues, and the alternatives. It discussed cautiously certain moderate steps in coordination and endorsed the appointment by the President of a nonpartisan committee of five to seven members to spend a year or two in comprehensive study. (Twentieth Century Fund, Facing the Tax Problem, New York, 1937, p. 450.)

Conflicts from overlapping taxing powers of different jurisdictions were believed susceptible to reduction but not to complete elimination because the latter implied too great a degree of centralization. (Ibid., pp. 370, 449.)

A moderate use of several devices in Federal-State coordination was suggested, since Federal-State relations would be more amenable to change by the plans of the special commission if no one device were extended too far. Meanwhile, some separation of sources, some sharing, and some crediting might be applied. The inflexibility of such devices, however, and their insensitivity to the factor of needs called for Federal aid. (Ibid., pp. 450–451, 426.)

Extension of the equalization principle was advocated for both Federal and State grants-in-aid. Where grants represented a substantial portion of the income of recipient units, increased exercise of control was suggested. (Ibid., pp. 426, 436.)

Little hope was held for acceptance of piecemeal tax coordination suggestions; hence the need for a comprehensive fiscal plan, including more than tax features and offering enough to every unit to guarantee agreement. Such a comprehensive plan, to be drafted by the special body, would cover taxation, expenditure, debt, and political controls. (Ibid., p. 450.)

Also recommended were continued State effort to remove horizontal conflicts and the adoption of the Massachusetts formula for allocation of corporate income. (Ibid., pp. 450, 436.)

In another section, the report stated: "complete coordination of the tax system cannot be achieved under a federal government. The most that can be hoped for is a series of compromises." (Ibid., p. 387.)

	Yes	No	Qualified
Increase in Federal control over education and equal decrease by States?	25	82	20
Increase in financial support for education by Federal Government, and decrease for States?	56	50	21
Highways, increase in control?	65	51	11
Highways, increase in support?	68	45	14
Crime suppression, increase control?	119	4	4
Crime suppression, increase support?	110	7	10
Prefer unitary government to Federal Government?	10	108	9
Prefer teamwork between States not now provided by Constitution be handled by State compacts instead of changing Constitution to increase Federal powers?	66	38	23
1926 80-percent abatement principle in death taxes?	79	18	30
Adoption of same principle for personal income taxes?	26	63	38
Adoption for corporate income taxes?	23	63	41
Death tax basically Federal tax with surtaxes collected by States that care to adopt them?	54	48	25
Same—personal income taxes?	40	58	29
Same—corporation income taxes?	45	56	26
Need of outside agency to check efficiency and integrity of Federal unit is sufficient justification for States to have their own death, corporation, and personal-income-tax collecting units?	7	100	20
Corporations federally incorporated, paying incorporation and annual fees to Federal Government and none to States?	64	40	23
Abolition of all death taxes except Federal, and distribution of part of proceeds to States?	49	58	20
Same—Federal personal income taxes?	30	80	17
Same—Federal corporation income taxes?	38	64	25
Same—Federal gasoline taxes?	31	81	15

From "Answers by American Professors of Public Finance to Questionnaire on Taxation with Special Reference to the Relationships of the Federal Tax System on the One Hand and of the State and Local on the Other," Mark Graves, president of New York State Tax Commission, Jan. 1, 1936.

(*b*) *Comments and proposals made by leaders in field.*

A few significant suggestions and opinions from those who have given much study to the subject follow:[40]

Paul Studenski suggested in 1936 that a special commission study not only the tax system but all Federal-State-local fiscal and expenditure relations. Such a body would be transformed into a permanent agency with a regional organization to develop cooperation on a national and regional scale in public works planning, the planning of other expenditures and methods for their financing.[41]

Commenting on the Social Security Act in 1936, Clarence Heer suggested the need for an intergovernmental budget-making organization to consider comprehensive budgeting of all governmental activities, avoiding, of course, the vesting of all fiscal authority in a single centralized body.[42] Elsewhere, Heer proposed a Federal-State commission on fiscal coordination of a planning and advisory nature to schedule all Federal, State, and local financial requirements and to develop a rational master plan of taxation. Such a commission would be expected to make recommendations to legislatures and the Congress. The commission might be established by reciprocal Federal-State legislation, possibly by interstate compacts to which the Federal government would be a party. In Heer's judgment, general fiscal coordination would not be developed by piecemeal efforts directed at individual abuses.[43]

Heer expressed the opinion that—

under modern conditions, it is becoming increasingly difficult to support public functions adequately and to distribute their costs equitably and efficiently on

[40] The remainder of this section is based mainly on a monograph prepared for this study: Russell Hinckley, Representative Quotations on Federal-State Fiscal Coordination.

[41] Paul Studenski, "A Tax Program for the Future," Taxation and Public Policy, Smith, New York, 1936, p. 174.

[42] Clarence Heer, "The Probable Effects of the Social Security Act on State and Local Finances," Proceedings of the National Tax Association, 1936, pp. 58-59.

[43] Clarence Heer, "Relations Between Federal, State, and Local Finances," American Economic Review, supplement, vol. 26, March 1936, p. 181.

the basis of a multiplicity of independent and semi-independent taxing jurisdictions, whose areas are for the most part small.[44]

He added that the impression that the coordination problem can be solved by some new set of specifications, scientifically arrived at by the experts, is illusory. There are issues at stake which are political in character and cannot be so settled.

Carl Chatters, executive director of the Municipal Finance Officers Association, stated in 1940—

We need a national study of the activities and revenues of the Federal, State, and local governments. Congress should appoint a special commission with sufficient staff to study the work being done by the Federal Government, the State governments, and the local governments, and the financial means which each governmental level has at its disposal.[45]

Roswell Magill stated—

We badly need * * * to have some commission clothed with authority to work out a plan for a better division of tax sources between the States and the Nation; for the elimination of the present overlapping and duplications of payments and reports.[46]

W. Brooke Graves urged Presidential appointment of a national commission to study the functions of government which are now being performed by each unit. It was held essential: (1) To determine the efficiency of performance of public services at various levels; (2) to clarify the conflicts and uncertainties in taxation; (3) to work out better intergovernmental personnel relations; and (4) to determine optimum units for specific governmental purposes.[47]

Secretary Henry Morgenthau Jr. expressed to the Tax Revision Council his recognition of the urgency of the coordination problem in 1935 as follows:

Conflicting taxation is an old problem, and not confined to the United States, but it grows more complicated, more difficult, and more acute with the years. At present we find it so acute in our country that it must be faced and the fact that we are facing it raises the hope that we shall soon be taking important steps to solve it.[48]

Clarence A. Dykstra, speaking from the point of view of the cities' sized up the problem as follows:

Our government units of the Federal, State, and local levels have vied with each other to tap the possible sources of public revenues. In this contest the cities have come out third best. * * * Left for the most part with a revenue system based on the general property tax, faced with tax delinquencies, unable to borrow, and compelled to buy with cash, cities have found themselves utterly unable to carry the burden of their services, their debt, and their relief. * * * The havoc created by our conflicting, overlapping, and contradictory tax policies both in urban life and in our industrial system must come to an end.[49]

In 1925, Edwin R. A. Seligman expressed the dilemma of federalism as follows:

The interests of the States must at all costs be safeguarded, but the difficulties inherent in a State administration of what has become national in character must be avoided.[50]

[44] Ibid., pp. 175 ff.
[45] Public Management, October 1940, pp. 309-310.
[46] Roswell Magill, "Trends in Public Finance," Taxes, January 1940, pp. 7, 55.
[47] W. Brooke Graves, "Readjusting Governmental Areas and Functions," Annals of the American Academy of Political and Social Science, January 1940, p. 209.
[48] Council of State Governments, Book of the States, vol. 1, 1935, p. 440.
[49] C. A. Dykstra, "City, State, and Nation," Municipal Year Book, 1937, International City Managers' Association, Chicago, 1937, pp. 5-6.
[50] E. R. A. Seligman, Essays in Taxation, Macmillan, New York, 1925, pp. 386-387, 389.

In general he favored an eclectic approach to the problem as suggested by the following:

In this system of coordination there will be room for all four methods, the realinement of governmental functions, the system of credits, the division of yield, and the system of supplements and additions. In the final outcome, success will be achieved only if due heed be given to the fundamental * * * principles of adequacy, certainty, economy, and flexibility, together with conformity to the demands of economic justice.[51]

Some support for the eclectic approach is also found in the statements of Mark Graves:

The Federal Government, like the biggest child in a family, seizes the largest, reddest, juiciest apples in the tax dish, monopolizes all of the important tax fields and leaves to the States and their localities the cull apples. States, on the other hand, enact tax laws without considering the impact of Federal taxes, taxes of other States, or the effect of their laws on the welfare and prosperity of the country as a whole.[52]

In my opinion, the solution will be found neither in complete segregation on the one hand, complete Federal collection on the other, nor in the crediting device in between. I think that in some combination of the three there will ultimately be found a solution.[53]

One of the strongest statements concerning the trend toward centralization was made by W. B. Munro, as follows:

Jurists may sob over the "vanishing rights of the States" but it is a fair guess that these rights will continue to dwindle as our problems keep growing in size. The steady erosion of State powers is bound to go hand in hand with the increasing complexity of our economic and social life. Nothing in the realm of political prophecy can be more certain than that the intrepid rear guards of the States' rights army are fighting for a lost cause. Or to change the metaphor, they are "plowing the seashore." [54]

Strong support for the centralization of the tax system can be found in the writings of Simeon E. Leland. For instance:

The ideal relationship between Federal, State, and local revenues is one of unity. The financial system of a nation should be highly, if not completely, integrated * * *. The administration of such a system should be centralized, or located where maximum efficiency can be secured. The revenue receipts produced by the system should be shared with all governmental units in such proportions and amounts as to maximize the social utility of government.[55]

Robert Murray Haig also has expressed preference for a centralized tax system but considerable skepticism as to its immediate feasibility:

In all likelihood, however, this ultimate step [centralization] will be a question for the consideration of our children's children * * *. Certainly the time is approaching, if indeed it has not already arrived, when every intelligent person must agree that justification exists on this ground alone [referring to rapid communication and transportation] for an extensive remodeling of the relation of the tax systems of the States and the Nation.[56]

On the other hand, James W. Martin has expressed skepticism of centralization and refers to "the cumbersome red tape necessitated by the size of the Federal administrative machine." [57]

[51] E. R. A. Seligman, "The Fiscal Outlook and the Coordination of Public Revenues," Current Problems in Public Finance, Commerce Clearing House, Chicago, 1933, pp. 274-275.
[52] Report of the Joint Legislative Committee on Interstate Cooperation, New York, Legislative Doc. No. 90, 1938, p. 157.
[53] "Discussion of Report of Committee of National Tax Association on Fiscal Relationships of Federal and State Governments," Proceedings of the National Tax Association, 1934, p. 184.
[54] W. B. Munro, "Do We Need Regional Governments," Forum, January 1928, p. 109.
[55] Simeon E. Leland, "The Relations of Federal, State, and Local Finance," Proceedings of the National Tax Association, 1930, p. 96.
[56] R. M. Haig, "The Relation of the Tax Systems of the State and the Nation," Lectures on Taxation, Commerce Clearing House, New York, 1932, p. 222.
[57] J. W. Martin, "State and Federal Relations in Taxation," Proceedings of the National Tax Association, 1935, pp. 308-309.

At the joint session of the special committees on coordination of the National Tax Association and the American Bar Association in February 1941, the variety of opinion on procedure for study of the problem was again apparent. Clarence Heer pointed out the "practical difficulties of ever getting action on a particular plan" and the failure of the earlier effort of the Interstate Commission on Conflicting Taxation to face and analyze all the issues, particularly in the political sphere. Fairchild stated his position that a thorough overhauling was not essential and that the financial stability of the States should not be threatened. Clifford Goes aptly commented on the need for coordination among the groups interested in coordination. Various members pointed out the need for approaching the subject through study of expenditures, grants-in-aid, extension of interstate reciprocity, use of interstate allocation formulas, use of Federal collection and sharing, and further use of crediting. J. A. Maxwell illustrated the sectional cleavages and the importance of political factors in the Canadian experience with the plans of the Royal Commission on Dominion-Provincial Relations.[58]

(c) *A classification of views.*

Summarizing individual reactions to the problems of intergovernmental relations, a rough classification of views is presented below. The names of proponents may be supplied by the reader. Eight groups may be distinguished according to the following views:

1. That which fears further centralization because it is thought to threaten larger expenditures and more taxes.
2. That which favors decentralization to preserve the independence and vitality of the States.
3. That which favors a strong centralized tax system to achieve greater order and efficiency.
4. That which favors a strong centralized tax system for better fiscal control.
5. That which favors centralization on the functional (expenditure) side.
6. That which favors an eclectic-pragmatic approach to the problem.
7. That which favors more central support for particular functions of government.
8. That which stresses the need of overhauling the tax system to achieve more coordination.

5. GENERALIZATIONS CONCERNING THE NATURE OF THE COORDINATION MOVEMENT

(a) Pressure for action for fiscal coordination has come principally from the States rather than the Federal Government. The latter has had the advantage of superior strength in its fiscal powers. State officials, individually and through their organizations, have played the leading role in the movement. Next in importance have been the academic students of the tax system. Business groups, with their principal interest in the cost of tax compliance and their concern about the over-all tax load, have taken some part. Organizations and individuals interested in particular functions (such as education) have joined in the movement sporadically.

[58] "A Meeting of a National Tax Association Committee," National Tax Association Bulletin, vol. 26, March 1941, pp. 182-184.

(*b*) An outstanding observation is that there has been no ground swell of popular interest in this problem. The absence of participation by farm and labor groups is highly conspicuous. Perhaps this is accounted for by the fact that the direct tax systems of the States and the Federal Government have largely bypassed these groups.

(*c*) A further important observation is that there has been no crystallization of popular or any other opinion on the subject of coordination. There is no public state of mind on the question.

(*d*) The experts themselves are by no means agreed even on the diagnosis of the problem, and they are much less agreed as to remedies. The unanimity of purpose usually associated with a *movement* has been hardly discernible.

(*e*) Even the term "coordination" has been loosely used and ill-defined. To one group in the coordination movement what is vaguely labeled "coordination" has meant merely the preservation of the status quo in State and local functions and tax sources. As the magazine, Fortune, described the position of one State officials' group: "What they meant by coordination was mainly to have the Federal Government stop poaching on what they considered their private tax preserves. But in this, the Governors were merely whistling in a dark created by shutting their own eyes." [59]

At the other extreme are those who find no remedy for interstate tax conflicts and overlapping of Federal and State tax systems short of complete Federal centralization of tax administration and of many other functions. To some the term "coordination" implies much milder forms of cooperation in tax administration. Seligman attempted to make a distinction between integration and coordination. The former might take the form of subordination; the latter might include reciprocal adjustments designed to preserve equality between the whole and its parts.[60] Fiscal subordination would cover complete support of one level of government by the other, while coordination would result from limited use of devices such as realinement of functions, tax crediting, single collection and division of yield, and systems of tax supplements and additions. Moreover, few of the participants in the movement have troubled to define their concepts of the term "coordination" or to distinguish between tax coordination, fiscal coordination, and general coordination. The term "coordination" has often been a loosely used but eminently safe term for political utterances, allowing room for all shades of political preference.

(*f*) The movement has been characterized by much wishful thinking and rationalization. Those who conceive the possibility of a completely single, simple, logical tax system without any sacrifice of State and local independence have not probed very deeply. Those who have endorsed Federal collection and distribution with the thought that their own jurisdiction would be assured the full benefit of its own resources do not have a very realistic view of the propensities of Congress. One critic [61] has summarized this limitation of the movement, certainly a fair characterization of part of it, as follows:

> Too much of the movement is mere subscription to the magic word "coordination," without further statement of aims or plans. Such endorsement is symptomatic of incomplete thought processes, an inclination to dodge political issues, or bafflement in the face of the problem. A form of rationalization has developed by

[59] "United States Taxes," Fortune, vol. 16, December 1937, p. 200.
[60] E. R. A. Seligman, op. cit., pp. 262-65.
[61] Russell Hinckley, in a supplementary memorandum prepared for this study.

which satisfaction or complacency is derived from endorsing the word, handing the problem to a committee which also endorses it, delivers a few generalizations, and recommends "further study." It is not surprising, then, that the coordination movement has been a series of impasses and deferments—an interchange of words rather than ideas.

Much the same note runs through this critic's more general characterization of the movement as follows:

The coordination movement, then, has been a series of political speeches and arguments on the merits of centralization versus decentralization in taxation, administration of public services, or both. It is a confused clamor by business and taxpayer groups for somehow bringing "order out of chaos" in the tax field, or protest against heavy aggregate tax burdens, sometimes mistakenly identified with overlapping of Federal and State tax systems. It is the expression of desire for Federal assumption of functions or retention of such functions by the States, with or without Federal aid, by the officials and pressure groups interested in promoting the function.

It is the appointment of committee after committee by independent or joint associations of State tax officials, economists, lawyers, accountants, bankers, State legislators, State and local executive officers, chambers of commerce, and others. Many of these groups have attempted to bring solutions out of the spare-time attention to the problem by a few members. Throughout, there seems to have been an abiding faith that acceptable solutions would somehow evolve if enough feet were placed under the same table. There has also been a conviction that a group of specialists could draft a formula or set of specifications to satisfy all parties and resolve all the conflicts, when many of the issues involved are beyond the province of the expert. The flood of proposals for national surveys, permanent or temporary national tax commissions, and joint State-Federal agencies, especially in the past 5 years, is evidence of this faith.

There has been a quantity of individual academic consideration of the political ideas involved, much equal balancing of advantages and disadvantages and cataloging of coordination devices. On a few occasions, idealized systems of taxation and distribution of functions have been essayed. Not infrequently, the advantages of central tax administration have been enthusiastically developed up to a certain point at which the political questions and the "insuperable problems of distribution" are encountered and the whole matter left suspended.

In the past year, there has developed some coordination of various committees on fiscal coordination through joint meetings and interlocking directorates. This is particularly evident in the operation of the current committees of the National Tax Association, the American Bar Association, and the National Association of Tax Administrators. In the past, however, the lack of unanimity on specific plans within the same organization has been striking, indicating the lack of a common understanding of the concept of coordination and the problem to be solved, as well as an amazing diversity of individual political and economic beliefs and prejudices.

This statement perhaps overdraws the factor of futility and frustration in the coordination movement. Moreover, it is freely acknowledged that the present report is subject to many of the limitations stated above. A thorough review of the literature and history can leave the student exceedingly weary with the repetition and inaction. But this should not conceal the fact that the movement has at least brought urgent problems to public attention. Some limited action has resulted. The history of the coordination movement is filled with discouragement, but the final pages have not been written, and they may contain a vindication of the efforts of the pioneers.

D. Complaints and Objectives [62]

Taking a broad view of the subject of Federal-State-local fiscal relations, one may draw up a considerable list of the complaints against our so-called uncoordinated fiscal system. In the following enumeration no attempt has been made to exhaust the potentialities.

[62] Based in part on a monograph prepared for this study: Mabel Newcomer, Complaints Concerning Intergovernmental Fiscal Relations.

First, it is said that governments lose sight of the total burdens of overlapping taxes upon the taxpayer. It is said that a Federal tax may be reasonable and just and that a State tax may also be reasonable and just, when either is taken by itself, but that the combination may be an unreasonable and unjust load for the taxpayer to carry. It is complained that when the Federal Government considers new levies on income, inheritances, and consumption, it ordinarily gives little, if any, attention to present and prospective similar levies in the States.

Second (and closely related to the first), the States allege that the Federal Government leaves them inadequate tax resources. Both compete for the taxpayer's dollar, and it is alleged that the Federal Government, because of its superior strategic position, gets the better of the competition. The feeling is that the States (and perhaps the municipalities even more so) have too many duties and too few revenues with which to finance them. Especially the cities, with their enormously expensive services, second only in some cases to those of the Federal Government, are said to be "the forgotten man" of the revenue system. The property tax is said to be a quite inadequate instrument with which to tap their own resources and to take care of the rising burdens of adequate government. Moreover, it is claimed that neither the Federal Government nor the States can embark on a financial program with assurance that the other will not change its tax laws and thus upset plans.

Third, it is said that certain taxes, particularly in the war era, should be pushed to the utmost, and that this is impossible when the Federal tax system is superimposed upon a diversified State system. Thus, if the present combination of Federal and State personal income taxes in New York is excessive, it does not follow that the Federal tax is excessive in Pennsylvania, in the absence of a State tax. And if the two taxes in New York are not excessive, then the level of income taxation in Pennsylvania is needlessly low in the face of war needs.

Fourth, it is alleged that the great diversification in State taxes, combined with a complicated Federal system, creates too much confusion. This is irritating to the taxpayer and creates a high cost of tax compliance.

Fifth, it is said that duplicate Federal and State taxes create unnecessary costs of administration and compliance. The Federal auditors knock at the businessman's door one day, and the State auditors arrive the next. This is said to be both wasteful and irritating. Thus it is asked, why should we have both Federal and State liquor taxes when it would be so easy for the Federal Government to impose one levy for both? The Federal Government could collect from a few large distributors, whereas the States are obliged to collect from many wholesalers and even from some retailers.

Sixth, it is said that the application of State taxes to a national economic system involves impossible problems of jurisdiction and allocation and that much multiple taxation results. The taxpayer suffers from the attempt of each of several States to include in its tax base as much of his wealth and income as the law will allow. Thus, the cosmopolitan taxpayer is likely to find that in taxation the whole is greater than the sum of all its parts. Multiple taxation of this variety is in addition to and much more serious than a combination of Federal and State levies on the same base.

Seventh, for many years States and municipalities and taxpayers have expressed fears that this tax and that might be causing business and wealth to migrate to areas of lesser pressure. This is a very common theme of newspaper discussion, particularly in New York, but not confined to any one State or city.

Eighth, it is alleged that economic resources are unevenly distributed territorially throughout the country, with the result that certain areas have inadequate means to meet their needs, and that certain services, in which we are all interested and to which every American is entitled, suffer. Much wealth, it is said, is really a national product and should not be the exclusive source of support of particular areas and their governments. It is also alleged that certain governments, by the use of certain taxes, levy, in effect, on the citizens of other areas. Illustrating the last point, it is asked, what right has the State of New York to tax the transfers of stock in national corporations, or the State of Delaware to tax the stock of corporations whose assets are outside its borders?

Ninth, it is alleged that the central units of government frequently impose mandatory expenditures upon the lower units without regard to the latter's inadequate resources. This complaint is heard especially from those representing municipalities.

Tenth, there are problems which arise in the intergovernmental taxation of governmental instrumentalities. This is familiar in the application of local taxes to Government housing and in the long-standing issue of tax-exempt securities.

Eleventh, it is alleged that the tax system as a whole is regressive, repressive, and ill adapted to such important economic ends as full employment and the maximization of the national income, as a result of these independently exercised tax powers.

E. Experience of Other Nations With Intergovernmental Fiscal Relations

1. Summary of Devices Employed for Reconciling Conflicts

To provide a setting and perspective for this study a survey of the available literature concerning intergovernmental fiscal relations in certain federal systems of government was undertaken. This included the systems of Canada, Australia, Union of South Africa, Germany, Switzerland, Argentina, Brazil, and Mexico.[64]

Most of the recognized devices for reconciling intergovernmental financial conflicts are found in the financial systems of the eight federal states covered by this study.

Complete separation of tax sources is provided for by the Brazilian constitution of 1937. This is not supplemented by any large intergovernmental payments in order to adjust revenues to expenditures and consequently is fairly rigid. In practice, however, the constitutional provisions have not been strictly observed. The comprehensive German plan for coordinating the tax systems of the different levels of government—a system that was incorporated in the federal laws but never actually put into practice—contemplated complete separation of tax sources. The other countries have been moving away from separation of sources.

[64] A complete report on these countries will be found in a monograph by Mabel Newcomer prepared for this study, upon which this brief summary is based: Mabel Newcomer, Summary of Tax Systems—Reconciling Conflicting Taxes in Federal Governments.

Federal requisitions on states were originally provided for in Germany and Switzerland. They were used extensively for many years in Germany, but were levied in only a single year in Switzerland. There is no current instance of this device, unless the Mexican federal levy on state property tax revenues is to be classified in this way.

State (and local) additions to federal taxes, or federal additions to state and local taxes, are not widely used. The gasoline tax in Argentina is an isolated instance of a State levy on a Federal tax base. Some of the pre-war State and provincial income taxes in Australia and Canada resembled this, but the bases were not identical, administration was sometimes in the hands of the State rather than the Federal Government, and the States and Provinces still retained the power to make independent levies. The increases in Federal taxes resulting from the war, and the presumably temporary adjustments to meet this situation have suspended this type of coordination. The Federal Government of Mexico permits limited local additions to certain Federal taxes. The reversal of this system—Federal levies on State taxes—is found in Mexico, but does not form an important part of Federal revenues.

Shared Federal taxes distributed to States, provinces, and local governments are the form of coordination emphasized by Germany, under the 1919 constitution, and by Argentina, under the 1934 tax reforms. The German system was so unsatisfactory that continuous revision was necessary to keep it functioning. It was by no means self-adjusting. No detailed account of the operation of the Argentine system has been found, but some complaints of lack of provincial cooperation are recorded.

The crediting device does not seem to have been used outside of the United States between Federal and State governments, although it has been used between national governments for customs and income taxes.

Fixed grants for general State use are characteristic of the British dominion federations and the early Swiss federation. Australia has been most successful with these, although they have been frequently modified. Canada has found them particularly unsatisfactory. Both Canada and Switzerland have gradually substituted conditional grants. Canada has returned to the use of fixed grants with the war, however, and the Royal Commission on Dominion-Provincial Relations recommended that Canada restore this device to its former important position, with substantial modifications in the method of fixing and revising the grant (the national adjustment grant).

Conditional percentage grants have found their greatest use in Switzerland and Canada in recent years. The Swiss system was initiated early in the history of this federation to supplement the fixed grants, and it has completely replaced the original fixed-grant system. It seems to have been very successful. Canada, too, supplemented fixed grants with conditional grants, beginning somewhat later than Switzerland, but it never completely abandoned the fixed grants. Canada's conditional grants have been more successful than her fixed grants, but they have not proved thoroughly satisfactory. Other countries have used conditional grants, but not to the same extent as these.

Equalization grants based on an equalization formula have not been used by the federal governments under consideration. Special grants to poor Provinces and States in all three of the British dominions are an attempt to achieve the same results. Argentine grants to cover provincial deficits might also be included in this classification. Relief grants, which were widespread during the depression, were also related to need, but they were determined by the amount of State and local funds available for the purpose, or by administrative discretion, or they were determined by legislative action specifying fixed sums, rather than being based on a formula recognizing measures of ability and need.

Unified administration of duplicate taxes has solved some of the administrative problems in some countries. This solution has gone furthest in Australia. It is found also in Canada and Switzerland. Both Federal administration of State taxes and State administration of Federal taxes are in use.

Solutions for interstate frictions actually in operation are relatively few and inadequate. The interstate covenant seems to have been widely used in Switzerland but constitutional restrictions, as well as short-sighted self-interest, have kept agreements to a minimum. Australia has apparently been most successful in cooperative State action. The Canadian provinces attempted to eliminate multiple taxation in the field of inheritance taxation by reciprocal agreements similar to those found in the United States, but this movement has broken down. Reciprocity in provincial corporation taxation has not even been attempted. Trade barriers between States have been a problem in Argentina, Brazil, Mexico, Australia, and Canada.

There is some agreement as to the taxes left to State and local administration. The principal sources usually left to these are, as in the United States, taxes on real estate, motor-vehicle licenses, and miscellaneous business licenses. To a lesser extent the gasoline tax has been an important independent State revenue. The original attempt, characteristic of most Federal States, to allocate all important indirect taxes to the Federal Government and important direct taxes to the State and local governments has been abandoned. The income tax is everywhere a Federal tax, and death taxes are Federal in the majority of cases. State governments have not been completely eliminated from these fields, however, and the consequence is that the field of overlapping taxes has steadily increased.

Transfer of functions from the lower to the higher levels of government is found to some extent. The federal governments have not tended to take over administration completely in any of the important fields of state and local activity except for some welfare categories. Almost without exception federal governments have taken over some part of the welfare program on a more or less permanent basis in recent years. There is no agreement, however, as to which category is most suitable for federal governments.

The present war has given a new impetus to the tendency to centralize revenue systems. The movement differs from that of the last war, however, in reducing duplication rather than increasing it. During the First World War federal governments invaded the states' tax preserves to an unusual degree. During the present war they are monopolizing sources for which they had merely been competing hitherto. It is much too early to say whether this will be permanent or not, but it should be noted that many of the "temporary" measures of the First World War, such as the Swiss Federal income and property taxes, have never been abandoned.

2. REGIONAL PROBLEMS

The regional problems of a federal state arise from wide differences in the size of the constituent States; from differences in race, nationality, language, and religion; and from differences in economic interests.

Table 3 shows the range in the size of the constituent States for the 9 federal governments under consideration. Only Germany had a single State (Prussia) that comprised more than half of the total population and area. However, Argentina, Australia, Canada, and the Union of South Africa each has more than one-fourth of its population in a single State. And the United States and Mexico are the only Governments in which the largest State comprises 10 percent or less of the population. The United States has the largest number of States; the number for the other governments varies from 4 to 28.

TABLE 3.—*Population and area of 9 Federal Governments and their largest and smallest states* [1]

National State	Total population (millions)	Date	Largest State by population		Smallest State by population	
			Name	Percent of total	Name	Percent of total
Argentina	13.1	1940	Buenos Aires	26.55	La Rioja	0.84
Australia	[2] 6.9	1938	New South Wales	39.48	Tasmania	.38
Brazil	46.1	1938	Minas Geraes	17.26	Matto Grosso	.85
Canada	10.4	1931	Ontario	33.07	Prince Edward Island.	.85
Germany	66.0	1933	Prussia	61.55	Schaumburg-Lippe	.08
Mexico	16.6	1930	Vera Cruz	8.32	Colima	.37
Switzerland	4.1	1930	Bern	16.94	Appenzell I-Rh	.34
Union of South Africa	10.0	1937	Cape of Good Hope	36.35	Orange Free State	7.91
United States	131.7	1940	New York	10.24	Nevada	.08

National State	Total area (thousands of square miles)	Number of States	Largest State by area		Smallest State by area	
			Name	Percent of total	Name	Percent of total
Argentina	1,080	14	Buenos Aires	10.97	Tucuman	0.82
Australia	2,975	6	Western Australia	32.81	Tasmania	.88
Brazil	3,276	21	Amazonas	22.33	Sergipe	.46
Canada	3,467	9	Quebec	15.10	Prince Edward Island.	.06
Germany	182	17	Prussia	62.52	Bremen	.05
Mexico	764	28	Chihuahua	12.41	Tlaxcala	.20
Switzerland	16	22	Graubunden	17.22	Basel-Stadt	.09
Union of South Africa	473	4	Cape of Good Hope	58.61	Natal	7.68
United States	2,974	48	Texas	8.82	Rhode Island	.04

[1] The term "state" refers to state, province, or canton.
[2] There are also an estimated 51,500 aboriginals who are not included in the census.

Source: Statesman's Year Book.

From a political standpoint there is some advantage in the more even distribution in size, since it reduces the danger of domination of one interest at the expense of others. However, even in Germany the southern states were successful in obtaining important concessions from Prussia. And what the United States gains from having no single State in a position to dominate, it may lose—at least in part—from the multiplication of frictions that arise from such a large number of States. It is much easier to obtain the cooperation of 6 States than 48.

The two governments with the sharpest division in languages and religion are Switzerland—where four languages are officially recognized—and Canada, with its English Protestants and French Catholics. The original Swiss federation was predominantly German, but it has gradually added cantons where other nationalities are in the majority—apparently without undue friction. The fact that religious divisions cut across language divisions has probably prevented serious cleavage. In Canada, where the division is sharper, since the language and religion go together, there has been a good deal of friction. But the friction has come in questions of education and welfare services rather than in financial problems. In financial matters Quebec and Ontario have often stood together as against the Maritimes or the Prairie Provinces. Economic interests have proved to be the determining factor here.

The important division of economic interests has usually been between the agricultural elements interested in exports, and therefore in free trade, and the manufacturing and commercial elements interested in protection. Federal governments, with their control of foreign trade, must choose between these and endeavor to conciliate both. The division between the seaboard states and the interior is often, although not always, the same as the division between manufacture and commerce on one side and agriculture on the other. Other economic interests that occasionally cause division among the states are mining, lumbering, and fishing.

All the federal governments reviewed have these problems in some measure. The question is not merely that of protection or free trade. It extends to subsidies for specific industries, both manufactures and agriculture, to railroad and highway building, and to promotion of settlement in sparsely populated areas. The United States has probably subsidized manufactures less than any other country under consideration—except indirectly through the protective policy. All have heavily subsidized railroad building and agriculture.

It has been common practice in other countries, where one section appears to be suffering from the nation's protective tariffs, or from some other federal policy, to buy its acceptance of this policy by a grant to the state treasury. This is the origin of many, but by no means all, federal grants. The United States is in the minority in making no grants of this nature (at least not until the depression of the 'thirties).

3. FEDERAL-STATE DIFFICULTIES AND ADJUSTMENTS

Friction between federal and state governments arises primarily from the fact that the federal government has continually encroached on state tax preserves. There are, of course, other disagreements with regard to fiscal policy. The original and exclusive source of federal revenues—customs duties—has been developed with an eye to protective policies, rather than revenues, and protection has favored some industries—and the regions where these protected industries prevail—more than other industries and other regions. Railroad subsidies, likewise, have favored some regions more than others.

For the past 30 years, however, the steady increase in federal tax levies has resulted in protests from the underlying governments of every federal state. And these protests have become more frequent than protests concerning other federal policies. The amount of federal tax revenues has grown more rapidly than the amount of state and local revenues in every country for which the record is available.

All nine federal governments have introduced income taxes during this period. Six have introduced death taxes, bringing the total of federal death taxes from one to seven. The number levying some form of property tax has doubled—from three to six. Several federal governments have introduced excess profits taxes, general sales taxes, and gasoline taxes. All these are important sources of revenue, and all are regarded as suitable state taxes. In many instances the states were levying such taxes before the federal government imposed them.

This invasion of state tax preserves has not occurred without protests, and protests have usually been met with concessions—either in the form of grants or of shared taxes. Brazil alone has practically complete separation of Federal and State revenues, under the 1937 constitution. Germany, under the 1919 constitution, provided for Federal administration of income, sales, and other important taxes, and the States received substantial shares in consequence. Argentina followed this example in 1934, except that duplicate land and death taxes were permitted.

Switzerland and Mexico have reversed this process, turning over the administration of Federal and State taxes to the States. In Mexico, the form of the inheritance tax is determined by the Federal Government, the States acting merely as administrative agents, but retaining 60 percent of the proceeds. For the Mexican property tax, on the contrary, and for the Swiss income and property taxes, State and canton levies are independent of the Federal levy; and the bases of the Federal and canton taxes of Switzerland vary substantially.

The combined administration of income taxes in Australia, until the Commonwealth took over the state taxes in 1942, was in one instance (Western Australia) in the hands of the Federal Government, and in the others in the hands of the States. Here, too, there was no uniformity in the tax base at first, but this was gradually achieved.

Some of the Canadian Provinces, like Western Australia, accepted Federal administration of their income taxes before the Dominion took them over altogether in 1941. The Union of South Africa permits Provincial income taxes but definitely limits the amount of these taxes. Only in the United States are unlimited and independently administered State income taxes in force.

Competitive and independently administered death taxes are found in Argentina, Australia, Canada, and the United States. In other countries a single tax is shared (Mexico) or this tax is levied exclusively by the Federal Government (Germany and the Union of South Africa) or exclusively by the states (Brazil and Switzerland).

Federal property taxes are varied in form and do not usually duplicate state and local levies directly. Federal general sales and gasoline taxes are found in a few instances. Duplication of federal and state levies is found in the case of gasoline taxes, but not in the case of general sales taxes, except for small amounts in Canada.[65]

This makes it apparent that the diversity in the different systems is very great. It is apparent, also, that duplication of administration

[65] The provincial gasoline tax in Argentina is a surtax on the Federal levy.

has been avoided in many cases by delegating the administration of both Federal and State taxes to one or the other authority. This has occurred even where there are some differences in the tax base. The crediting device employed for death taxes in the United States is not in use in other countries.

Grants in compensation for tax sources given up by the States, and divorced from the yield of the Federal tax, were a common device when federal governments were first established, but they have been gradually abandoned, although both Australia and Canada have revived this form of grant as a (presumably temporary) war measure.

The form of grant that has met with the widest favor in adjusting Federal-State relations is the conditional, percentage grant. This form of assistance is useful in increasing central control. The States do not relinquish administration, and the substantial financial assistance weakens State resistance to Federal regulation. Equalization grants distributed on the basis of an equalizing formula are not found at the Federal level, although need was taken into account in the distribution of relief funds during the depression of the 'thirties.

In addition to the above summary concerning the application of coordination devices in other Federal systems, some further detail concerning the experience of Canada and Australia is submitted here.

4. CANADA'S FEDERAL FINANCIAL SYSTEM

(a) *Early history of Dominion-Provincial finances.*

The Federal Government of Canada lies between those of Australia and the Union of South Africa in the degree of centralization. It was established by the British North-American Act of 1867, passed by the British Parliament substantially as it was drawn up by representatives of the Canadian colonies at the Quebec Conference of 1864, and revised by the Canadian delegates in London in 1866.

The interests of the uniting colonies were widely varied. The Maritimes were greatly concerned with foreign trade; and the Province of Canada—particularly Upper Canada—was interested in westward expansion. There was also a sharp division of interests between the French and the English colonists, although they had already combined (in 1841) in the single Province of Canada.[66] The desire for union, fostered by the fear of the growing power of the United States and by the desire for similar expansion, overruled sectional differences, but the resulting federation was necessarily a compromise measure.

Under the terms of the act of 1867 free trade was established among the Provinces (sec. 121), and customs duties were levied by the Federal Government. Since these were the only tax revenues that had been levied by the Maritime Provinces, and since they supplied four-fifths of the tax revenues of the Province of Canada, this was a major sacrifice on the part of the Provinces.[67] In fact, it was necessary to make a special concession to New Brunswick and permit this Province to retain export duties on lumber (sec. 124), a privilege that it commuted for a flat annual grant of $150,000 in 1873.

[66] Upper and Lower Canada, which constituted this Province, became Ontario and Quebec after federation.

[67] If municipal taxes and the nontax revenues of the Provinces and municipalities are added to Provincial taxes, customs duties accounted for 45 percent of Canada's revenues in 1866, 72 percent of New Brunswick's revenues, and 75 percent of Nova Scotia's revenues. Royal Commission on Dominion-Provincial Relations, Canada: 1867–1939, Ottawa, 1940, book I, p. 44.

The Dominion took over Provincial railways and canals, together with the debts that the Provinces had incurred in building them, and also undertook the building of the Intercolonial Railway and the improvement of the St. Lawrence Canal system. Further, of course, it assumed the cost of national defense. Since these functions were responsible for 52 percent of the cost of Provincial and municipal governments in 1866, the gains to the Provinces were important. In fact, the yield of the customs duties in 1866 was very little more than the cost of national defense, debt service, and railway and canal expenditures combined.[68]

Since the per capita debts varied widely from one Province to another, it was agreed that the Provinces with debts in excess of $25 (except New Brunswick—which was allowed the full amount of its debt, $27.77) should reimburse the Dominion for the interest on the excess debt, and those with less should receive a cash subsidy equal to the saving to the Dominion. Under these provisions Nova Scotia received reimbursement for a debt deficiency and Ontario and Quebec suffered a deduction from their per capita grants for excess debt.

The per capita grants were the principal direct contribution of the Dominion to the Provinces. They were set at 80 cents per capita, the amount of Nova Scotia's estimated deficit under the new arrangements. New Brunswick again protested special need and received a special grant of $63,000 (about 25 cents per capita) to be discontinued at the end of 10 years. Nova Scotia also received a special grant, beginning in 1868, and amounting, like that of New Brunswick, to approximately 25 cents per capita. Finally, each government was given a flat grant for the support of general government. This grant varied in amount in the different provinces, but was not closely related to population.

Under these provisions Ontario received something less than half of its revenues from Dominion subsidies during the following decade; Quebec received approximately half, and Nova Scotia and New Brunswick received about 80 and 90 percent, respectively. Public lands were the only other important source of Provincial revenues. Provincial taxes were negligible. Some of the municipalities were levying substantial taxes on real estate, but at the time of federation only Ontario had well-developed municipal government and the Maritimes had none. The North America Act of 1867 had granted the Provinces and their municipalities the exclusive right to levy direct taxes, but the Provincial governments were slow to develop them.

The original system of grants was established by bargaining rather than by following any well-coordinated plan. Since the most important source of Provincial revenues had been customs duties it was necessary to offer the Provinces some other form of income if they were to continue any important government functions. The founders of the Federal Government chose grants, rather than new Provincial taxes. The amount of the per capita grant was determined by examining actual budgets and selecting the smallest apparent per capita deficit—that of Nova Scotia—as a standard. The compensation for less than average debts and the counterbalancing charges for larger debts was a bargain made after long debate. Ontario, the Province most eager for federation, made the greatest sacrifices. New Brunswick, the most recalcitrant, received the greatest concessions—an

[68] Ibid., pp. 39–40.

extra debt allowance, the privilege of an export tax on lumber, and a special grant. The allowances for government were added at the London Conference in 1866 as a final "bribe" to the Maritimes.[69]

Two years later, when it became apparent that Nova Scotia had made a poor bargain, her per capita and debt allowances were increased to correspond to those of New Brunswick. Prince Edward Island joined only after its railway debt became unmanageable, and after it had persuaded the Dominion to give it a debt allowance double that of Ontario and Quebec, and a special grant because it had no income from public lands.

It is impossible to trace, in this brief account, the details of the development of Federal-Provincial relations over the three-quarters century of federal history. A few high points and some generalizations will have to suffice. Much of this history is a story of continual bargaining, complaints, and compromises concerning the per capita and flat-sum grants, arrangements concerning which were frequently revised and adjusted to accommodate the increase in the number of Provinces from four to nine and for other reasons.

If one Prairie Province obtained a special concession the others demanded the equivalent. And if the Dominion yielded to the Maritimes the Prairie Provinces became more insistent in their claims. Drought in the 1930's brought genuine need and new requests, and loans were added to outright grants. Special commissions have been set up from time to time to consider the merits of specific complaints or the question as a whole, but nothing has come of these but piecemeal and compromise legislation.

In spite of these concessions, the total sums granted were moderate compared with the job to be done, and most of the Provinces were in such straitened circumstances that there was little opportunity for waste.[70] Only Ontario and Quebec, the Provinces receiving the least in subsidies, as measured by population or by total revenues, were in a satisfactory position.

The eagerness of all the Provinces for rapid development of their resources was largely responsible for financial strain. With an area larger than that of the United States the population in 1901 was one-fifteenth as large. Moreover, most of the people were concentrated at the two ends of the continent, with scattered settlements in between forming a narrow belt along the southern border. Many of these communities were in closer contact with their neighbors across the border than with other Canadian cities and towns. Sectional interests were as varied and conflicting as those in the United States, and perhaps more sharply defined because of the greater distances between settlements. The Prairie Provinces of Manitoba, Saskatchewan, and Alberta formed one sectional group. The Maritimes—New Brunswick, Nova Scotia, and Prince Edward Island—formed another. British Columbia was completely cut off from the other Provinces. And Ontario and Quebec represented the manufacturing and urban interests as far as these had been developed. But even Ontario and Quebec were divided by nationality, language, and religion.

[69] See the account in W. Eggleston and C. T. Kraft, Dominion-Provincial Subsidies and Grants, Research Study for the Royal Commission on Dominion-Provincial Relations, Ottawa, 1939, pp. 1-6.

[70] Eggleston and Kraft, op. cit. p. 18. There is not complete agreement with regard to this. Extravagance and waste are sometimes charged. (See also, J. A. Maxwell, Federal Subsidies to the Provincial Governments in Canada—1937, Harvard University Press, Cambridge, 1937, pp. 91, 130.)

Under these circumstances national unity demanded transcontinental railways, where purely economic considerations might have dictated feeder lines to such railways already in operation in the United States. And rapid economic development demanded, in addition to railways and highways, free homesteads and other forms of subsidy to settlers.

Dominion grants were increased in response to these needs, but the proportion of Provincial revenues from Dominion subsidies declined from 29 percent to 8 percent between 1913 and 1930. In the same period the revenue from the public domain declined from 25 percent to 10 percent. This was the period of rapid expansion of Provincial taxes. As noted above, the Provinces had been experimenting with all the important forms of direct taxation before 1900, but the yield of corporation, personal income, real estate, and death taxes combined amounted to less than a million dollars in 1896, and only 8 percent of all Provincial revenues. By 1913 these taxes had risen to nearly one-fifth of the income of the Provinces, and by 1930 they had reached $48,000,000, or more than one-fourth of the total income. Gasoline taxes and automobile licenses were producing even more than income and inheritance taxes in 1930.

(*b*) *Development of conditional grants.*

In 1913 the Dominion introduced a grant for agricultural instruction. The sum appropriated was $10,000,000 to be distributed during a 10-year period. Some discretion was given to the Federal minister of agriculture in apportioning this money, but the purpose and manner of expenditure were not stipulated in detail, no matching funds on the part of the Provinces were required, and little checking on expenditures was made. When the original appropriation was exhausted the grant was abandoned. This was the Dominion's first experiment with conditional grants.[71] The merits of this grant have been questioned but its restoration was urged at the Dominion-Provincial conference in December 1935.[72]

This grant for agricultural instruction was followed by further grants for specified purposes. The Dominion was in a better position to support expanding government services than the Provincial governments, and it sought to develop through percentage grants the services it could not provide directly under the constitution. A grant for employment offices was introduced in 1918, the Federal subsidy to be matched from Provincial funds. The annual appropriation of $150,-000 was apportioned on the basis of total Provincial expenditures for this purpose, with the limitation that the Federal contribution should not exceed the Provincial. Actually Provincial expenditures were approximately double the Federal. This was discontinued with the adoption of a national system of unemployment benefits in 1941.

Other grants have been made for venereal disease control (1919); technical education (1919); highways (1919); and old-age pensions (1928).

[71] For a detailed account of Canada's conditional grants, see L. Gettys, The Administration of Canadian Conditional Grants, Public Administration Service, Chicago, 1938.

[72] Eggleston and Kraft, op. cit., p. 43.

Beginning in 1930, the Dominion assisted the Provinces and municipalities in the support of relief. These relief subsidies were made available to both Provinces and municipalities and were used for both home relief and work relief. The Federal contribution normally varied from 25 to 50 percent of the cost, depending on the nature of the relief provided and on whether it was sponsored by Provincial or municipal governments. The total sum made available for this was in some years left to the discretion of Federal authorities.

The first subsidy, made in 1930, was assumed to be temporary and no elaborate controls were established. As it became apparent, however, that this form of aid was to exceed any other subsidy in amount, and to continue indefinitely, Federal controls were increased. Administration of these funds was in the hands of the Department of Labor, but a National Employment Commission, appointed in 1936, assisted in the work. The auditor general audited Provincial and municipal accounts. Controls were of administration rather than relief policies, but they apparently were more effective than the controls established for other Federal-aided activities.[73] These subsidies were discontinued in 1941 with the introduction of the national unemployment insurance program, which is supported 80 percent from pay-roll taxes and 20 percent from Dominion revenues. Ordinary relief is again the responsibility of Provincial and local governments. Unemployment offices were taken over by the National Government at the same time.

The Canadian conditional grants have tended to be discontinuous and intermittent. In 1942 only one was in effect—that for old-age pensions. Control by the Federal Government has tended to be weak and ineffective.

The rapid rise of the conditional grants in the 'thirties overshadowed developments in the older unrestricted grants. When the conditional grants reached their peak in 1937 they amounted to 86 percent of all Dominion subsidies to the Provinces. Even with the decline in unemployment relief in 1940 these conditional grants continued to account for nearly three-fourths of the whole. The unrestricted grants remained almost constant in amount from the time that conditional grants were introduced in 1913 to the introduction of the temporary grants now paid in lieu of Provincial income taxes.

Most of the Canadian conditional grants have been percentage grants designed to stimulate the expansion of Provincial services. None of them has attempted equalization of resources. Even the relief grants seem to have been on a strictly percentage basis, with the Province or municipality providing at least half of the cost. It is, therefore, particularly interesting to note that the Royal Commission on Dominion-Provincial Relations, while finding the conditional grants an improvement on the older statutory grants, does not recommend their continuance. In their place it recommends complete Federal support and administration of unemployment relief, and a national adjustment grant to equalize the cost of other Provincial and municipal services.[74]

The advantages claimed for such a grant are that it makes it possible for the Provinces to support an acceptable national minimum standard of services and at the same time gives them independence in administering the functions allotted to them. It is to be determined by the

[73] Oettys, op. cit., p. 170.
[74] Royal Commission on Dominion-Provincial Relations, op. cit., book II, pp. 125 ff.

difference in cost between an acceptable standard of services and the yield of a uniform and approved provincial tax system. In short, it is to cover the approved deficit, just as the original per capita grant of 1867 was designed to cover the approved deficit. It differs from the per capita grant, however, in important respects. The formula for measuring deficits is an elaborate one, taking into account a wide variety of factors; whereas the deficits of 1867 were determined by examining actual expenditures and revenues and disallowing certain items. Also, the national adjustment grant would be revised once in 5 years, whereas the original per capita grant was fixed for an indefinite period. Since the basis of the new grant would be at once definite and flexible, and the amount adequate, it is presumed that the political bargaining that followed the establishment of the original per capita grant would be eliminated.

It is not proposed to abolish the grant for old-age pensions, and other small conditional grants are regarded as permissible. Since the only other conditional grant of importance at the time that the recommendations were made was that for unemployment relief, and unemployment relief is to be taken over completely by the Dominion under this plan, it is apparent that the new equalizing grant is to replace the per capita grant, the government and debt allowances, and the special grants. This proposal parallels in many respects the British block grant of 1929. The formula differs, however, as do also the functions the plan is designed to aid.

Changes in grants have occurred since this report was made, but the changes have been in response to the war emergency and do not conform closely to the recommendations of the Royal Commission. Except for the abolition of the unemployment relief and employment services grants, the changes are intended to be for the period of the war only. First, all special grants have been abolished and in their place the Provinces receive subsidies scaled to their requirements. Second, each province receives from the Dominion, in compensation for gasoline rationing, the difference between its 1940 gasoline tax collections and current collections. Third, each province receives a grant equal either to its personal and corporation income-tax collections in 1940 or the difference between the cost of its debt service and the yield of its inheritance tax. The choice is left to the province. These arrangements are temporary, and in compensation for the loss of Provincial and municipal taxes on corporation and private incomes for the period of the war. [75]

All the Provinces had accepted this plan by the end of 1941. Saskatchewan, New Brunswick, Nova Scotia, and Prince Edward Island selected the second alternative since they had not developed their income taxes to the extent that the other Provinces had and therefore profited more by the debt option. In addition, these same four Provinces and Manitoba were granted extra budget-loss or fiscal-need subsidies, or both. These amounted to more than $3,000,000 and the compensatory grants came to a little over $81,000,000.[76] The total sum of $84,000,000 is larger than all the other grants combined, and will bring Provincial revenues from Dominion grants to more than the yield of independent Provincial sources.

[75] J. A. Maxwell, Recent Developments in Tax Coordination in Canada, National Tax Association P oceedings, 1941, pp. 676–677.
[76] Tax Administrators News, vol. 6, February 1942, pp. 13–14.

(c) *Allocation of tax sources to different levels of government.*

The British North America Act of 1867 specifically allotted direct taxes to the Provincial and municipal governments and retained the important indirect taxes for Dominion purposes. The Provinces were slow in developing direct taxes, although by 1913 they were obtaining approximately one-fifth of their revenues from death taxes, corporation taxes, real estate taxes, and personal-income taxes. Corporation and death taxes were by far the most important of these, and the personal-income tax was negligible, although two Provinces were using it.

The municipal governments had depended upon real estate taxes from the beginning, obtaining 80 percent of their tax revenues from this source in 1866 and about 90 percent in 1913. The remaining municipal tax revenue came largely from licenses at this latter date, although municipal income taxes were in use in Nova Scotia.

The municipal real estate taxes were in some instances primarily—or even exclusively—on land values. The Provincial taxes on real estate were similar in form but small in amount, totaling only 2 percent of the whole. Three Provinces did not levy them at all.

Separation of sources was practically complete, in 1913, as between the Federal Government on the one hand, and the Provincial and municipal governments on the other. This situation was changed, however, by the pressure of war financing.

The Dominion attempted to obtain the necessary revenues for the First World War through the increase of taxes already in force and through borrowing. When these sources proved inadequate, it began to encroach on Provincial sources through the levy of a gross receipts tax on the income of certain classes of corporations in 1915, and through the levy of a war profits tax in 1916. The personal income tax was introduced in 1918. As a result of these changes the Dominion obtained about one-third of its tax revenues from personal-income and corporation taxes in 1921. The Provinces were likewise obtaining approximately one-third of their revenues from similar taxes, although the extensive development of Provincial income taxes came somewhat later.

This overlapping of Federal and State revenues has increased steadily since the First World War. In 1937, sales taxes were being levied by two Provinces and by the municipalities of a third Province. Corporation income taxes were in force in six Provinces (as compared with four in 1921), and personal income taxes, Provincial or municipal, were in use in every Province (as compared with three in 1921). Stock transfer taxes were found in the Dominion and two Provinces.

Death taxes, amusement taxes, motor-vehicle licenses, and gasoline taxes (the last having been introduced since 1921) were in use in all Provinces in 1937, but were not used by the Dominion. Real-estate taxes were in use in both Provincial and municipal governments in every Province, although Provincial levies were small.

In spite of this extensive overlapping, the Federal Government was still obtaining approximately three-fourths of its tax revenues from customs excises and sales taxes which (except for the small sales taxes in three Provinces) were not duplicated by Provincial or local levies. And the Provinces in turn were obtaining more than three-fifths of their revenues from sources that were not duplicated by either Federal or municipal governments.

Although the problem of overlapping taxes has not been as acute in Canada as in the United States, the Royal Commission on Dominion-Provincial Relations, reporting in 1940, deplored the duplication involved in the field of personal income taxes, and recommended the withdrawal of the Provinces and municipalities from this field. For some time the Dominion has collected personal income taxes for four Provinces—Ontario, Manitoba, Prince Edward Island, and Quebec—with apparent satisfaction. It was pointed out in the hearings before the Royal Commission that if the two definitions of income were the same, joint collection would be feasible even though deductions, exemptions, and rates differed.[77]

The friction in the field of corporation taxation has been even greater than in personal income taxation because of the greater diversity in taxes—more than one base being employed by the same Province in some cases. The allocation formulas used by the different Provinces to distribute inter-Provincial income have been designed with an eye to the maximum revenue for the Province in question and lead to a substantial amount of double taxation.[78] In fact, the corporation tax situation has been similar to that in the United States. For these, as for personal income taxes, the Royal Commission recommended exclusive Dominion taxation.

Inter-Provincial competition has been serious for inheritance taxes as well as for corporation taxes, and multiple taxation has resulted. The Provincial taxes vary widely. For the 30 years from 1907 to 1937 reciprocal provisions to avoid such multiple taxation were gradually established between Provinces, although the two wealthiest Provinces, Ontario and Quebec, failed to reach an agreement. These gains were lost, however, when Alberta canceled her agreements with Ontario, British Columbia, and New Brunswick in 1937. Other cancelations followed until only the agreement between British Columbiá and New Brunswick remained.[79] This situation is serious since these taxes have been one of the most important sources of Provincial revenues. Even as late as 1937 they produced more than Provincial income taxes on corporations and private individuals combined.

Until 1941, death taxes were never a source of Federal revenue in Canada; but in spite of this long and unbroken tradition of exclusive Provincial taxation, and the importance of these taxes in Provincial budgets, the Royal Commission urged the transfer of these taxes, also, to the Dominion, considering them wholly unsuitable for Provincial administration.[80]

As late as 1940, in spite of the shrinking of customs duties and the growing dependence on income taxes, more than half of the Dominion's tax revenues came from sources not used by the Provinces. However, the demands of war financing have revolutionized the Dominion's taxes in this war as in the last. A conference of Dominion and Provincial finance ministers, in January 1941, "ended in an unedifying squabble.[81] Ontario and Alberta were the Provinces most opposed to the recommendations of the Royal Commission, and only Manitoba and Saskatchewan were definitely in favor of them. Thus

[77] Royal Commission on Dominion-Provincial Relations, op. cit., book II, p. 177.
[78] Ibid., p. 113.
[79] W. H. Wynne, "Double Taxation of Inheritances in Canada," National Tax Association Bulletin, vol. 26, January 1941, pp. 111-113.
[80] Royal Commission on Dominion-Provincial Relations, op. cit., book II, pp. 118-120.
[81] The Economist, March 29, 1941, p. 412.

no action was taken on the Commission's recommendations. This has not prevented the Dominion from invading Provincial tax preserves, however. In April 1941, the Dominion imposed a 3-cent gasoline tax and an inheritance tax. Both of these taxes had been exclusive Provincial taxes up to this time. At the same time it asked the Provinces to relinquish both personal and corporation income taxes for the period of the war. This was done by all the Provinces by the end of the year.

These changes leave the Provinces with no important independent sources of revenue. Even the motor-vehicle licenses are in some measure in competition with the new and heavy manufacturers' tax on motor vehicles.

(*d*) *Conclusions.*

The centralizing forces that have been found in other federal governments are at work, also, in Canada. This Government, in spite of the greater powers with which its Federal Government has been endowed, resembles that of the United States more closely than that of any other under consideration in the distribution of functions and tax revenues among the different levels of government.

The most important difference in intergovernmental fiscal relations in the early years was the extensive use of Federal grants to the Provinces in Canada. The history of these does not indicate, however, that this is a device that brings satisfactory fiscal relations. On the contrary, it would seem to have introduced additional frictions.

Today the important difference is in the greater limitation on Provincial tax sources in Canada than on State tax sources in the United States. This is, however, a war emergency program and may not prove to be permanent.

The Dominion and Provincial Governments have apparently not cooperated as successfully as the Australian Commonwealth and states in working out their problems. Four Provinces had turned over collection of their income taxes to Dominion officials before the the Dominion took over the tax completely. Three of these Provinces had permitted the deduction of Dominion income taxes from income for Provincial purposes. Against these credits is a long list of inter-Provincial and Dominion-Provincial quarrels. The country is faced, of course, with very real differences in economic interests from one Province to another, but the same seems to be true for Australia. There seems to be agreement that Australia has gone further than Canada in reconciling conflicts, but the reason for the difference is not clear.

In view of Australia's progress in the development of cooperative procedures, the Royal Commission's recommendation for a permanent commission to review and advise on Dominion-Provincial fiscal relations, and to recommend changes,[82] is perhaps more important than their recommendations concerning the immediate allocation of taxes and functions, and adjustment grants. In any case, the Royal Commission on Dominion-Provincial Relations has made a genuine step forward in making a thorough investigation and comprehensive recommendations, and it seems probable that the resulting discussion may bring advances in solving Canada's problems when opportunity offers.

[82] Royal Commission on Dominion-Provincial Relations, op. cit., book II, pp. 272-273.

5. AUSTRALIA'S FEDERAL FINANCIAL SYSTEM

(a) *Early history.*

The Federal Constitution of Australia was adopted in 1900 as the culmination of a period of more than 50 years of agitation for some form of union. A customs union had been considered as early as the 1840's, and other plans for federation followed.[83] The constitution of 1900 was enacted by the British Parliament, after adoption by the Australian colonies. The principal debate among the colonies centered around methods of representation. This was a dispute between the large States (as measured by population) and the small States. Second only to this was the dispute concerning the division of revenues. This involved both the question of sharing between the Federal Government on the one hand and State governments on the other, and the question of the basis of distribution of any State share. The fact that New South Wales and Western Australia had adopted a free trade policy, levying duties for revenue only, whereas the other States had developed a protectionist policy, introduced a further difficulty.

The Australian Commonwealth was granted more power than the Federal Government of the United States, and less power than the Dominion of Canada. The enumerated powers of the Commonwealth were more extensive than those of the United States, including banking, insurance, old-age pensions, marriage and divorce, and ultimate control over the financial position of the States (art. 51 of ch. 1, and ch. 4). On the other hand, the reserved powers went to the States.

At the time of federation the States had already developed a system of internal excises. Each State also had an inheritance tax, and all but Western Australia and Queensland had income and land taxes. In spite of this, the principal source of revenue for the States as a whole was the customs, as is to be expected in a country as dependent on foreign trade as Australia has been.[84]

The division of revenues finally agreed upon was to give the customs duties to the Federal Government (arts. 86 and 90), with the temporary limitations that Western Australia was to continue to impose its own duties on domestic imports for a period of 5 years (art. 95), and that all States might alter and regulate tariffs on interstate and foreign imports for a period of 2 years.[85] The Federal Government took over collection and control immediately, however, and after the transition period, regulation of foreign and interstate trade was the exclusive function of the Federal Government.

The surplus over Commonwealth expenditures, to equal at least three-fourths of the proceeds of the customs duties, was to be distributed to the States for a period of 10 years, either directly or by applying them to State debts assumed by the Commonwealth (art. 87). This so-called Braddon clause was unsuccessfully opposed by New South Wales. It was further provided that special grants might be made to the States for the first decade at the discretion of Parliament

[83] For a full discussion of these developments see the Cambridge History of the British Empire, Macmillan, New York, 1933, vol. 7, ch. 15.

[84] About one-third of the products of all Australian industries combined were exported in the decade 1917 to 1927. G. L. Wood, "Survey of Production and the National Income," Annals of the American Academy of Political and Social Science, vol. 158, November 1931, p. 26.

[85] K. O. Warner, Introduction to Some Problems of Australian Federalism, University of Washington Press, Seattle, 1933, p. 125.

(art. 96). The distribution of the customs duties, after the first 2 years, was to be in proportion to consumption of the goods taxed rather than in proportion to actual collections.[86] It had been agreed that the ultimate basis of distribution should be population, but that a transition period was needed to enable the States to build up other sources of revenue.[87] The Surplus Revenue Act of 1908 took the first step in this direction by providing for the distribution of surplus revenues, other than the proceeds of customs duties and excises, in proportion to population.[88]

As in the case of Canada, the unconditional grants to the Provinces have been a subject of continued negotiation and revision. The development of overlapping taxation also follows a pattern fairly familiar in both Canada and the United States.

(*b*) *Overlapping taxes and Federal-State cooperation.*

Until 1910, the Commonwealth and States had virtual separation of tax revenues; but the new Commonwealth levies duplicated several State sources. All the States were concerned by the introduction of Commonwealth taxes on land, income, and inheritances, since all were depending on these sources of tax revenue. In 1912 two-fifths of State tax revenues came from the income tax alone, and nearly four-fifths came from income, inheritance, and land taxes combined. And in 1935, four-fifths of the State taxes and one-fifth of the Federal taxes came from these overlapping sources. Local governments have depended on rates, similar to the English local rates, for most of their tax revenues. These are levied on rental values, but in some measure they overlap the State and Federal land taxes.

The Commonwealth land tax was reduced in the early 1920's by the abandonment of the tax on leaseholds. The tax on freeholds continued, however, although the rates have been lowered from time to time.

The abandonment of the Federal income tax was proposed by the Commonwealth in 1923, in return for the relinquishment by the States of the per capita grant from the Commonwealth. This would have reduced the revenue for Commonwealth purposes materially, since the yield of the Federal income tax had far exceeded the per capita subsidies to the States from 1917–18 on. It was the States, however, that rejected this proposal.[89]

The 1923 plan looked toward complete separation of Commonwealth and State revenues, with the Commonwealth abandoning direct taxes and the States giving up indirect taxes. The proposal to abandon some of the Commonwealth direct taxes—this time the taxes on land and estates—was considered again in 1926, but no action was taken on it. By this time, the Commonwealth and States had begun to solve some of the problems of overlapping tax bases in other ways, and separation of revenues received less and less attention at the Federal-State conferences that ensued.

Attempts to coordinate Federal and State taxes had begun shortly after overlapping Commonwealth taxes were introduced. A plan for

[86] Customs Act of 1902, quoted in Warner, op. cit., p. 130.
[87] The Cambridge History of the British Empire, vol. 7, p. 449.
[88] Warner, op. cit., p. 136.
[89] Australia, Royal Commission on Taxation, Second Report, 1934, Canberra, 1934, p. 53.

making income taxes, land taxes, and probate duties uniform in all but rates was proposed in 1916 at a conference of State premiers, and in 1917 a bill was introduced to provide such uniformity for the income tax. This was rejected by the States. In 1918 it was suggested that the Commonwealth should collect State taxes, and in 1919 the Commonwealth Treasurer offered to collect all the States' direct taxes at one-third of the cost to the States, but the States did not accept the offer.

However, in 1920, Western Australia agreed to amalgamate its staff of tax administrators with that of the Commonwealth and to turn over the collection of most of its taxes to the Commonwealth. And in 1923 the other States made an agreement with the Commonwealth for State collection of Commonwealth income taxes. The Commonwealth reimbursed the States for their services and it continued to administer the tax for incomes from more than one State. The Commonwealth and State taxes on land and estates are separately administered, but the Commonwealth assesses both the Federal and State entertainment taxes.[90]

The advantages of this procedure are savings in cost of administration coupled with higher standards of administration. It also saves the taxpayer inconvenience and reduces evasion. It is not completely satisfactory, however. The Royal Commission recommended that a joint Commonwealth-State authority should assess and collect all direct taxes and the sales tax.[91] Also, R. M. Haig states that this change is widely recommended by Federal and State officials as the best form of administration.[92] If the choice is between Federal and State administration, however, the preference is for Federal administration.

This unification of administration did not result in uniform taxes, but it probably had some influence in this direction. In 1932, a uniform income tax statute was drafted, the main provisions of which were later adopted by every State except Tasmania. This achieved substantial uniformity in the allocation of corporate income for State taxes.

In addition to this the State tax officials cooperate informally to a marked degree. The State tax commissioners have agreed, for purposes of bank taxation, to examine the books of banks whose head offices are within their jurisdiction, and to allocate the profits to the different States together with a suggested assessment. Since banking is in the hands of a very few large banks with branches throughout the country this has resulted in substantial assistance. For other large corporations, also, the tax commissioner of the state of head office undertakes to notify the commissioners of other States in which the corporation's business is carried on of the percentage of net income which the corporation allocates in each State.[93]

Unification of administration had not accomplished enough to meet the war emergency, however. In March 1942, the Committee on Uniform Taxation recommended that the Commonwealth be made the sole tax authority in the field of income taxation for the duration

[90] Ibid., p. 62.
[91] Ibid., p. 63.
[92] R. M. Haig, "Amalgamated Federal-State Tax Administration in Australia," National Tax Association Proceedings, 1937, p. 379.
[93] Ibid., p. 376.

of the war and one year thereafter.[94] It proposed that the state be reimbursed in proportion to collections in 1939–40 and 1940–41, with special consideration for States with special financial problems. This was recommended primarily because the high rates were thought to make uniformity more than ever essential. In addition it was noted that there would be a saving, with Commonwealth administration, of £250,000 annually in salaries.[95] The committee suggested, further, that this centralization might be extended to other taxes. The Commonwealth Parliament passed an act providing for an exclusive Commonwealth tax on incomes in June 1942. The constitutionality of this measure was immediately challenged, but it has since been upheld by the High Court. The States are reimbursed for their losses.[96]

Standardization of death duties and joint administration of these taxes was recommended by the Royal Commission on Taxation in 1934,[97] but this was regarded as of less importance than uniformity of the income taxes. The wide variations in existing land taxes make standardization of this tax impractical, in the opinion of this Commission, but uniform and centralized valuations have been urged.[98]

(c) *Grants-in-aid to specific States and for specific functions.*

From the beginning of federation there has been disagreement among the States with regard to the Commonwealth's protectionist policy and other Federal policies. Some States have claimed that these were detrimental to their industries, and consequently to State finances, and have demanded compensation.

The Commonwealth's protectionist policy has been repeatedly protested by the agricultural and mining States—Western Australia, South Australia, and Tasmania—as interfering with their export trade. Western Australia also claimed heavy losses from the Federal policy of fixing the price of gold during the war, and from competition of the Commonwealth savings bank.[99] The Commonwealth has not admitted these specific claims, but it has provided special aid for Western Australia and Tasmania for the past 30 years, and for South Australia since 1930.

The Commonwealth Grants Commission was established in 1933 to make recommendations concerning special grants (under art. 96 of the Constitution). It was designed to serve as an "independent tribunal to decide questions on which the treasuries had never been able to agree." [1]

The commission has made elaborate studies of differences in State needs and ability to pay as a basis for estimating the amount of special aid needed. It gave careful consideration to the claims of "disabilities from federation"—that is, special losses from Commonwealth tariffs and other Federal policies, but concluded that these could not be used as a basis for determining the amount of special grants. Consequently, compensation for damages has been displaced by ability and need as the measure of these grants, and the Commonwealth

[94] Australia, Committee on Uniform Taxation, Report, March 28, 1942, p. 1.
[95] Ibid., p. 11.
[96] New York Times, July 24 and July 26, 1942.
[97] Royal Commission on Taxation, Fourth Report, 1934, pp. 176 ff.
[98] Ibid., p. 215.
[99] Parliament of the Commonwealth of Australia, Conference of Commonwealth and State Ministers, Melbourne, 1926, to Consider the Financial Relations between the States and the Commonwealth, 1926, Victoria, pp. 15 ff.
[1] Australia, Commonwealth Grants Commission, Seventh Report, 1940, Canberra, 1940, p. 24.

income-tax levy is used as one of the principal factors determining ability to pay.[2]

The States of South Australia, Western Australia, and Tasmania regularly appeal to this commission for substantial increases in their special grants; and the unfavorable consequences of Federal policies are as regularly cited in support of their claims. Budget deficits and geographic handicaps are also advanced as reasons for special assistance, and details of the Grants Commission's measures of need are criticized; but Federal economic and fiscal policies—and especially the tariff—continue to be offered as one of the principal arguments for special assistance.[3]

Deficits, actual and threatened, influence the commission's decision. In fact, its objective is to prevent state bankruptcy rather than to raise the standard of specific government services. In this respect it is working for the same end as the Loan Council discussed below. In taking deficits into account it does not, of course, encourage reckless spending, for it demands some assurance that the States aided are levying reasonably heavy taxes and are also spending carefully. The "deficit" toward which it contributes is a reasonable deficit rather than the actual one.

In addition to the complaint that these special grants are not large enough, the States criticize the lack of a permanent basis for these grants. The necessity for pleading their case year by year is deplored.[4]

(*d*) *Federal assistance through direct Federal support of governmental functions.*

The Commonwealth has not left the States with the responsibility for all important internal functions, but it has assisted by assuming complete responsibility for certain functions, rather than using grants-in-aid. National defense, including pensions and interest on the war debt, amounted to less than one-third of 1937–38 expenditures. The cost of invalid and old-age pensions, a function introduced in 1908, falls entirely on the Federal Government. The cost of these pensions exceeded State expenditures for all charitable purposes in 1937–38. Federal health expenditures likewise exceed State health expenditures. Education, however, has been left entirely to State and local support. It has never formed as large a part of State expenditures in Australia, however, as it has in the United States.

Local expenditures are relatively small, amounting to less than one-fourth of State expenditures in 1938. In sharp contrast to the States in this country, the Australian States have normally borne the brunt of Government costs. Australian State expenditures in 1938 were substantially greater than Federal and local expenditures combined.

State expenditures continued to outrun revenues after the First World War, in spite of Commonwealth assistance, and State debts increased 50 percent in the first half of the 'twenties.

(*e*) *Federal assistance for State debts.*

Before the First World War the Commonwealth had had no difficulty in balancing its budget. Its debts in 1913 amounted to only about one-third of its annual revenues and debt service accounted

[2] Ibid., pp. 15–16.
[3] Ibid., pp. 48–49.
[4] See, e. g., Conference of Commonwealth and State Ministers, February 16-28, 1934, Canberra, 1935, pp. 16 and 50.

for less than 4 percent of its annual expenditures. The States, however, had been borrowing heavily to finance the railways and other public works that seemed essential for the development of the country. State debts accounted for 97 percent of total Commonwealth and State debts in 1914, and the interest charge on these amounted to 25 percent of all State expenditures and far exceeded State tax revenues. Many of the projects for which the debts had been incurred were self-supporting, and land sales were still yielding substantial revenues. But most of the State enterprises did not bring immediate profits to State treasuries, however desirable they may have been. And there was a tendency to refund debts instead of providing for repayment.

The largest per capita debt in 1914 was that of Western Australia—£106 as compared with an average of £64. Tasmania, the other State receiving special assistance from the Commonwealth at this time, had a per capita debt about equal to the average, but interest charges in both of these States far exceeded Federal aid.[5]

With the First World War the Federal debt increased rapidly, until in 1920 it reached a sum about eight times the annual tax revenues, and the interest charges alone took more than one-third of the tax revenues.

Meanwhile the States had been having increasing difficulty in meeting their expenditures. New South Wales was able to borrow directly from the United Kingdom, but the other States borrowed from the Commonwealth, which in turn borrowed from abroad. This form of Commonwealth aid to States was introduced in 1916 and continued after the war was over. It did not, of course, reduce the demands on State revenues except insofar as it reduced the rate of interest at which these States could borrow. Except for this assistance, the Commonwealth aid to the States, including special grants, was less in the years immediately following the war than it had been in the first years of federation.

In addition to these special aids, other forms of Commonwealth assistance to the States were developed. The first instance of a Federal grant for a specific purpose occurs with the road grants, introduced in 1923. The first appropriation for this was £500,000. This was doubled the following year, and has grown since to £4,000,000. To obtain road grants suitable projects must be submitted, and approved by Federal authorities, and the State itself must provide 15 shillings for every 20 shillings from the Commonwealth. Finally, any State's share in this Federal grant is limited by its population and area—three-fifths of the total appropriation being allotted on the former base and two-fifths on the latter. The fact that the projects must be approved by Federal authorities has extended Federal control in this field.[6] The Federal grants meet an important part of the cost of State highways. The major part of the cost of road building and maintenance falls on the States, however. These obtain substantial revenues from motor-vehicle taxes, but the gasoline tax goes to the Federal Government.

No other State function has been subsidized to any great extent by the Federal Government. In 1931 and again in 1937 small subsidies

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[5] Australia, Commonwealth Bureau of Census and Statistics, Finance Bulletin No. 29, Canberra, 1938, p. 37.

[6] Warner, op. cit., pp. 143-146.

for unemployment relief were provided, and beginning in 1936 small grants have been made for local public works, mining, forestry, and youth employment. All these combined were only about one-tenth of the road subsidy in 1937–38.[7] The grant-in-aid for special functions, which has become such an important feature of the Canadian and United States systems, has met with little favor in Australia.

The revision of Federal-State financial relations between 1926 and 1929 was more extensive than any of the changes since the founding of the Confederation. The per capita grant was abandoned and, under the financial agreement of December 12, 1927, the Commonwealth took over the entire amount of State debts. The sums appropriate to replace the former per capita grant were applied to interest on these debts. The balance of interest payments—much the larger part of the total in each State—was paid by the States. In addition to these provisions, it was agreed to set up a sinking fund for State debts outstanding, toward which the Commonwealth would contribute 2s. 6d. for every £100 of debts and the States would contribute 5s. For new debts it was agreed that the Federal and State Governments would contribute 5s. each for every £100. These changes brought immediate financial gains to the States, but they were made "at the point of the pistol," according to the Premier and Treasurer of New South Wales.[8]

The generous contribution of the Commonwealth toward the sinking fund for new debts made some form of control essential. For this purpose the Australian Loan Council was officially established.[9] This Council was authorized to approve the terms of all loans, and their conversion, renewal, and redemption. The timing was fortunate. The council was in operation before the depression.

Under the Melbourne agreement of August 1930, the Commonwealth and the States agreed to stop overseas borrowing until current short-term indebtedness could be taken care of and to limit internal loans to approved public works which would be self-supporting. This was followed by the financial agreement of May 1931, which provides for a reduction of 20 percent in all government expenditures, the conversion of internal debts with a 22½-percent reduction in interest rates, increased taxation, and also certain reductions in bank and other interest rates. This did not completely balance budgets but it did materially improve the financial condition of the Federal and State Governments.[10]

The deficit financing made necessary by depression gave the Loan Council very great power over financial policy. It could force economies in expenditure and it could force the development of new revenue sources.[11] New South Wales had defaulted on its debt just before the financial agreement of 1931, and this default brought the real test of the Loan Council's power. In spite of determined opposition from New South Wales, the council was able to acquire rights to practically the whole of this State's tax revenues if they were needed to meet interest payments. According to Copland, the State that fails to meet interest on its debts may lose its independence. He points out

[7] Finance Bulletin No. 29, p. 11.
[8] Conference of Commonwealth and State Ministers, February 16–28, 1934, p. 19.
[9] This had existed as an extralegal body, set up by agreement between the treasurers of the Commonwealth and the States, prior to 1927, largely to avoid competitive loan flotations (Warner, op. cit., pp. 151–153).
[10] E. P. MacCallum, "The Australian Financial Crisis," Foreign Policy Reports, vol. 7, Sept. 16, 1931, pp. 267–270.
[11] D. B. Copland, Australia in the World Crisis, 1929–33, Macmillan, Cambridge, 1934, pp. 76–77.

that the States, banded together, may outvote the Commonwealth, but the Commonwealth is sufficiently influential to obtain the support of the majority of States in dealing with any dissenting member.[12]

In 1934 the Loan Council distributed £2,000,000 in proportion to population, and in each of the following years, 1935 and 1936, it distributed £500,000 in this way. This money was used in the States to cover deficits, although this use was not stipulated. By 1937, budgets were largely balanced, thanks to improving economic conditions and pressure from the Commonwealth and the banks.[13]

(*f*) *Evaluation of Federal-State financial adjustments.*

The outstanding features of the Australian Federal-State fiscal relations are the extensive cooperation between Federal and State Governments on the one hand and among the States on the other. This cooperation is well developed both in the administration of the tax laws and in debt policy. Cooperation started in purely voluntary efforts on the part of government officials. In some cases where this has proved successful, it has been formally adopted by law. In other cases it remains on a voluntary basis.

Why Australia has been more successful than other countries in this respect would be difficult to say. It has all the variations in industrial conditions—and the consequent sectional conflicts—that are to be found in any large country. It is, of course, approximately the same size as the United States. It has even greater problems of communication and transportation than the United States because of its sparse population. The one obvious advantage that Australia has over the United States is the relatively small number of States—6 as compared with 48. Seven people can sit around a table and discuss their problems as 49 cannot. This is undoubtedly a factor of some weight.

Australia has not, of course, solved all the problems of Federal finance. There have been difficulties with interstate trade barriers. At the 1934 conference of Commonwealth and State ministers the Premier of Tasmania protested that Victoria had been keeping Tasmanian potatoes out on the false charge of corky scab.[14] No record has been found, however, of attempts to levy protective taxes, and there is no evidence that the problem has been as serious as in the United States and some of the Latin American countries.

The friction resulting from the determination of the special grants is apparently substantial, although the Grants Commission itself seems to be reasonably satisfied with results. The policy of the Loans Commission has obviously improved the credit standing of the States, but it is not always acceptable to them individually. And the gradual encroachment of the Federal Government on the States' domain is frequently protested. The Commonwealth's request that the States give up their income taxes for the duration of the war in return for a fixed grant was rejected by the Loans Council, and when Parliament provided for this in spite of State opposition four of the six States (Victoria, Queensland, South Australia, and Western Australia) challenged the law (unsuccessfully) as unconstitutional. The High Court upheld the Commonwealth, however.[15]

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[12] Copland, op. cit., pp. 82-83.

[13] J. A. Maxwell, "Recent History of the Australian Loan Council," Canadian Journal of Economics and Political Science, vol. 6, February 1940, p. 23.

[14] Conference of Commonwealth and State Ministers, February 16-28, 1934, p. 37.

[15] New York Times, July 24, 1942.

6. CONCLUSIONS CONCERNING FOREIGN FEDERAL SYSTEMS

It is concluded from a survey of foreign intergovernmental relations that none of these federal states had found a thoroughly satisfactory method for coordinating fiscal systems. The wide diversity in the financial relations of the federal and state governments in the different federal states seems to be largely historical accident. There is little family resemblance among the British dominions or among the Latin-American federations. Where countries have made a radical revision in financial relations in recent years they have not followed any one pattern. Argentina chose a system based on shared taxes. Brazil chose separation of sources. The Canadian Royal Commission urged a block grant. Australia has been experimenting with joint federal-state administration.

No panacea has been found. The fact that Australia has been fairly successful with fixed and unearmarked grants where Canada has permitted the same device to become a political football is further evidence that there is no self-operating system. Moreover, the conditions that have favored Australia—primarily the small number of States—are also to be found in Canada. And the marked differences in economic interests that have caused trouble in Canada are to be found in equal measure in Australia.

Australia's comparative success with cooperative administration—both between the Federal and State authorities and among States—indicates that this may accomplish more than any rigid system of shared taxes, fixed grants, or division of tax sources, in reconciling conflicts. It will not offer a complete solution even under the most favorable conditions. And it is apt to prove more cumbersome in this country, with its 48 States, than in Australia or Canada where the number of authorities is much smaller. Nevertheless it is possible that a permanent commission representing different interests could reduce the frictions.

F. Conclusion

Having sketched the background of our present situation in intergovernmental fiscal relationships in terms of its origins, the history of the coordination movement, the nature of complaints lodged against our present institutions, and the experience of other countries, we are now prepared to proceed with a more intensive analysis of the problem and its solutions. In part II, the over-all problems—those independent of particular taxes and expenditures—will be considered. Part III will deal with intergovernmental relations in terms of specific taxes and expenditures.

It is concluded from the introductory survey that coordination and cooperation rather than subordination and coercion is the answer to intergovernmental fiscal problems.

Much valuable energy has been wasted unnecessarily in quarreling over the proper sphere of the Federal Government and the States when the seeds of solid achievement lie in the scantily tilled field of intergovernmental cooperation and coordination. Progress in this field requires some willingness to compromise, to surrender vested interests, to forget jealousies on the part of both the Federal Government and the States.

An analysis of the history of the fiscal coordination movement in the United States, and of experience in other countries, suggests that a pragmatic approach to the problem of intergovernmental fiscal relations is likely to be most fruitful. The pragmatic approach does not exclude the necessity of some analysis of long-run principles and interests. But hopes for a solution of the fiscal coordination problem, or for a comprehensive single plan for immediate adoption, are doomed to disappointment. Some scholars have rejected the idea of "nibbling" at the problem bit by bit as entirely inadequate, but it is this unspectacular method that promises most in the way of progress in what must be a cooperative venture. Indeed, the preoccupation of the critics with grandiose plans for fiscal coordination may account for the rather low score of achievement to date.

The survey of foreign experience indicates that no federal form of government has developed an entirely satisfactory method for coordinating its fiscal system—much less a single panacea. Examples of almost all coordination devices can be found in foreign experience, the selection and pattern depending considerably upon historical accident. What has worked well in one country has not always been successful in another. Australia has achieved notable success in cooperative administration, one of the least spectacular approaches to the problem, but it has the great advantage of having only six States for the Federal Government to work with. The means must be adapted to the nature of the problem in the case of each tax (or expenditure) and each country.

Coordination of fiscal systems is more difficult in a federal than in a unitary state. This is partly because the federation superimposes an additional layer of government, so that there are at least three overlapping levels of government to be supported. More important, however, is the fact that there are two coordinate governments—the national and the state—with independent and overlapping powers. This is, of course, the essence of a federal state.

Since both Governments occupy the same geographic territory, it is inevitable that they will draw on the same economy for support. It is inevitable, also, that the extent of the powers of each authority will never be sharply defined, no matter how carefully drawn the constitution may be; and that overlapping and conflict will ensue. Each authority tends to guard its own sphere of action jealously, and to resent encroachment by the other authority.

Under these conditions there can be no completely logical and clear-cut solution of fiscal problems. The united and uniform fiscal system of which some administrators dream is possible only in a unitary state. The best that can be achieved in a federal state is a working compromise, even as the federal state itself is, in its origin, often a compromise.

It needs to be remembered also that all movements toward coordination involve, to some extent, a choice of values. Coordination aims at uniformity and finds one of its principal causes for action in the compliance costs and irritations associated with diversities of State laws and practices. But these diversities can be defended too, as experiments in new and different techniques. Those who dislike centralization think of uniformity as vicious rather than beneficent; they apply the adjective "deadly" to what the centralizers seek. Here as in many other matters of social policy it is not possible to have our cake and eat it too. It may be possible, however, to achieve some results without great loss of values of any sort. There are areas in which diversity serves no useful purpose at all.

This report seeks a middle ground in the coordination problem. On the one extreme are the strong centralizers, who feel that State and local fiscal independence has served its usefulness and is no longer compatible with modern economic facts. The report of the Canadian Royal Commission goes far in this direction. At the other extreme are those who are satisfied with what we have and who argue that the frictions and wastes of uncoordinated taxation are the necessary price which we wisely pay for our federal system with its large measure of local freedom. Both of these groups are more realistic than the hybrid school which hopes for a completely coordinated fiscal system with no shift in the division of governmental powers.

A great many people would applaud a report which recommended the centralization of all the major taxes in the hands of the Federal Government. This would provide a simple, logical, orderly, and well-coordinated tax system. Going further in the same direction, all the major expenditure functions might also be centralized. This would avoid the confusion of transfers and would enable the application of the receipts where they are most needed. Such a program would enable us to discard largely some 165,000 units of government. It would give the Federal Government quite ample fiscal powers to deal with our undependable private economy. But there is no assurance that the resulting unwieldy product would not have more internal incoordinations and inefficiencies than the external ones so apparent in our present makeshift arrangements. And the loss in intangible values might be even more serious.

But we think that there is another and sounder middle ground which accepts the framework of the American governmental system and seeks no large shift in the division of power. This view starts with the observation that Federal-State relations of all sorts have been marked by coolness, distance, suspicion, jealousy, and much confusion. Governmental problems in our modern era have become so large and vital, and participation in a united attack upon them is so essential, that a new attitude, facilitated by new institutions, should be the minimum acceptable program of fiscal modification. While much weight needs to be given to the values associated with autonomous local government, these have to be balanced against the advantages, such as reduced confusion and wider perspective, which attend central control. A priori generalizations concerning centralization are of little use. Each specific problem has to be considered on its own merits. In some cases federalization of a function may (by a balance of the interests) be warranted; in others, retention of the function by States and municipalities or further decentralization may be called for; and most often, joint participation, in one way or another, may be the best solution. Decentralization within the sphere of Federal activities may also have a place in the picture. The presumption should favor decentralized control, probably, but it is by no means a final or conclusive presumption.

A change in attitude of revolutionary proportions seems to be needed. The American governmental system has never been viewed by most public officials as a unit with loyalties for the entire system evoked and encouraged. If the mayor of a municipality feels that a change in the Federal income tax would embarrass his own government, he is likely to feel no great concern whether the change is needed to strengthen and equalize the Federal system of personal taxation. Federal administrators show equally unfortunate blind spots. Very often in addition they lose a proper sense of proportion and conclude that all wisdom and authority are concentrated in Washington. State officials who complain about this attitude when it is observed in Federal officials often exemplify it themselves in dealing with municipal representatives. Some of this is but the necessary limitation of human beings. But much of it could be eliminated by more conscious effort.

This approach to the problem calls for a high degree of genuine mutuality. State suspicion that intergovernmental cooperation will be mostly Federal domination must be dispelled. Unfortunately, the suspicion is not entirely groundless. One of the spokesmen for the States illustrates a quite general attitude by recalling the old anecdote of the butcher who was allowed to sell horse meat with the qualification that he mix it 50–50 with rabbit meat. Later accused of violating this rule he explained that he had followed it literally: "50–50—one horse, one rabbit." But a program of full and genuine mutuality is entirely possible.

The middle way which we have sought to strike has some claim to acceptance as the American way. American belief in the dispersion of initiative and in safety in numbers is very deep. The pragmatic approach, adapting machinery to the necessities of time and place is also American in tone. Finally the views here taken, that private enterprise should be encouraged, not hampered in carrying as large a share of the future economic load as its performance will justify; that government, nevertheless, must be relied upon to insure an end-product in security and well-being compatible with a developing social conscience—these, too, are a part of the American tradition.

PART 2

OVER-ALL PROBLEMS IN INTERGOVERNMENTAL FISCAL RELATIONS

CHAPTER II

COORDINATION DEVICES AND INSTITUTIONS

A. Agencies and Instrumentalities of General Coordination

1. MACHINERY OF AMERICAN GOVERNMENT

Some account of the origin and evolution of the American Federal system and its division of powers was presented in the introduction. Suffice it here to observe first, that the machinery of government in the United States is very elaborate, consisting of over 165,000 States, counties, cities, villages, towns, school districts, special units, and the Federal Government. The model for most of this machinery was devised either before or shortly after the Revolutionary War and it is not surprising that some lags have developed in adjustments to modern conditions. Secondly, it may be observed that very little attention was paid by the fathers to the matters of coordination in the functioning of this machinery or to instrumentalities of coordination either on the horizontal or the vertical planes. It was intended, apparently, that the Federal Senate should represent the States; the original machinery for the election of Senators was set up with this in view but has since been changed. Congress represents the States quite faithfully and adequately in most respects but it does not supply the contact with Washington needed by State administrators. In the absence of official coordinating institutions, a very large amount of unofficial machinery designed to promote cooperation and coordination has developed.

2. THE INTERSTATE COMPACT

The fathers did authorize in the Constitution one bit of machinery which might be used for cooperation and coordination. This was the interstate compact. The provision of the Constitution governing the matter stated that: "No State shall, without the consent of Congress * * * enter into any agreement or compact with another State." [1]

The interstate compact appears to be a logical means of adjusting differences among the States. On several occasions the Supreme Court has remarked [2] that conference, negotiation, and perhaps arbitration, would seem to be a more profitable procedure than litigation. And if the compact looks like a promising device for settling disputes, why not apply it positively to the joint promotion of the general welfare?

[1] United States Constitution, art. I, sec. 10, par. 3.
[2] Cf. *New York* v. *New Jersey* (256 U. S. 296, 313 (1921); 41 Sup. Ct. 492, 498).

(a) *Volume and early history of compacts.*

Compacts are no new instrument; their history goes back not only to the Constitutional Convention but even to Colonial times. The constitutional provision concerning compacts has been described as "the republican transformation of the needed approval by the Crown." [3] The early use of the instrument was largely in the settlement of disputes concerning boundaries. One of the most famous of these fairly early applications was that of Virginia and West Virginia, dealing with the settlement of debt when the latter dissociated itself from the former and became a State. The agreement appears to have been none too satisfactory in this instance, for 40 years of negotiation and litigation were required to convert the debt agreement into dollars and cents.[4]

New interest in compacts, new purposes for their use, and an increase in their application have developed in the twentieth century. Writing in 1925, Frankfurter and Landis referred to the compact as an instrument of very considerable potentiality largely unexplored.[5]

Through 1941, Congress has authorized State compacts in 49 instances and has consented to 29 compacts (aside from 21 instances when boundary agreements have been ratified or authorized).[6] Eighty-six interstate compacts, including the 21 agreements relating to boundary lines, appear to have been ratified by at least some of the States concerned.[7] The precise status of all compacts is difficult to determine with accuracy. Many now in process, or to be concluded under general authorization, require further congressional approval upon final agreement among the States as to specific terms.

From 1934 to 1940 alone, 22 compact arrangements have been authorized or consented to in some form, including consent to one amendment of a previously authorized compact.[8]

(b) *Purposes and instances of recent compacts.*

Compacts have been classified by the purpose into six major categories as follows: [9] (1) boundary and jurisdictional adjustments; (2) regulation of interstate streams, harbors, and water resources; (3) construction and maintenance of interstate public works; (4) conservation of natural resources; (5) interstate tax adjustments; and (6) regulation of certain types of activities for social or economic reasons.

Of these, the first three, and particularly the first, have been historically the most common. Examples of the second are the agreements effected or pending concerning antipollution programs for the Delaware, Potomac, and Ohio River Basins. These agreements had the sponsorship of the Council of State Governments. A project fostered by the Federal Government concerned the distribution of water resources of the Colorado River attending the construction of Boulder Dam. This compact, consented to by Congress in 1928,

[3] Felix Frankfurter and J. M. Landis, "The Compact Clause of the Constitution—A Study in Interstate Adjustments," Yale Law Journal, vol. XXXIV, No. 7, May 1925, p. 694.

[4] Ibid., p. 699.

[5] Ibid., pp. 688, 729.

[6] Information from L. S. Morey, Chief, Inquiry Section, Legislative Reference Service, Library of Congress.

[7] Ibid.

[8] Council of State Governments, Book of the States, 1941–42, Chicago, 1941, pp. 57–61; and Book of the States, 1939–40, Chicago, 1939, pp. 124–127. From these 2 sources and "Interstate Compacts," State Government, vol. 9, June 1936, pp. 118–121, a fairly complete listing of the 86 compacts may be obtained.

[9] Garland C. Routt, "Interstate Compacts and Administrative Cooperation," Annals of the American Academy of Political and Social Science, January 1940, p. 97.

involved seven States and an acute disagreement as to the proper settlement. By 1940, however, only six of the seven States had finally accepted the settlement, and the proceedings were considerably delayed by litigation. Arizona's ratification in 1939 will become effective when California and Nevada accept a tri-State compact on water distribution.[10]

The third type of compact is exemplified by the Port of New York Authority agreement, one of the most ambitious and successful ever undertaken. The New York harbor borders the State of New York on its eastern and northern shores, and New Jersey on the west and south. By an agreement accepted in 1920, a self-sustaining corporation was established, to be managed by a Board of Commissioners representing both States. The Authority built and operates, among other facilities, bridges, tunnels, and a freight station. That it has been a business success has been acknowledged, but it is said to be handicapped by an insufficient grant of power.[11] Construction and power of condemnation must be authorized by joint legislative action and State Governors may veto any proposed action.

The fourth type of compact, aiming at the conservation of natural resources, was exemplified by the successful conclusion of an agreement in 1935 among several of the States for the conservation of oil and stabilization of the oil-producing industry. Not all the oil-producing States were included, and five States must reenact ratification every 2 years. Agreements concerning taxation—the fifth type—have been rare, but one such agreement was negotiated between Missouri and Kansas exempting from taxation certain waterworks property owned by their municipalities outside State boundaries.[12]

Agreements for purposes classified as social or economic have been still more rare. Illustrative of this category is the blanket consent of Congress in 1934, for crime compacts covering interstate supervision of parolees and probationers, ratified by 31 States through 1940.[13]

In 1934 an experiment in the use of interstate compacts to foster uniform labor legislation was tried. A conference of representatives from New York and four New England States set up a permanent commission to investigate and report to the various States on matters affecting labor. The Commission had advisory powers only. A subsequent conference at Spring Lake, N. J., attempted to secure a ban on child labor. This included representatives from a wider group of States, among them North Carolina, but the task proved too difficult for the assembly and no action developed from the meeting. In 1937, however, Congress consented to the Concord Compact of 1934, signed by 7 States and dealing with minimum wages for women and children. It had been ratified by Massachusetts, Rhode Island, and New Hampshire by 1940.

(c) *Limitations of compacts.*

(1) *Delay in negotiation.*—A procedure which requires agreement of at least two State legislatures and Congress is likely to be slow in development. It has been argued that the consent of Congress is not required where no Federal issue is involved, but even if true, this

[10] Book of the States, 1941-42, p. 57.
[11] National Resources Committee, Regional Factors in National Planning, 1935, pp. 40-41.
[12] Ibid., p. 37.
[13] Book of the States, 1941-42, p. 57.

exception would not often occur.[14] Congress, of course, as illustrated above, can give a blanket consent. The President stated in 1939 that it would be unwise to establish the policy of granting consent in advance to those compacts described only in broad outline, and that the customary procedure in resubmission of such compacts to Congress after final State approval should be followed.[15] At least one critic has argued that the reasons for requiring Congressional consent to interstate compacts have now disappeared and the requirement should be abolished.[16] This would require an amendment to the Constitution and, if adopted, would leave no safeguard against interstate action inimical to citizens of States not involved in agreements.[17] Moreover, there appears to be no evidence that the Federal Government has greatly hampered interstate compacts and in some cases it has assumed a leading role in promoting them.

In all important present federal systems throughout the world, the federal government is charged with the control of interstate relations—preventing hindrances to interstate trade, settling interstate disputes of various kinds, and preventing discrimination by individual states against the citizens of other states. Only in the United States, Switzerland, and the Latin-American federations have constitutions gone so far as to forbid the States to make compacts with one another without the express permission of the Federal authorities.[18]

The Swiss Cantons have availed themselves frequently of the express privilege granted them in the Constitution of making conventions among themselves, especially in the field of tax-law enforcement.[19]

As previously stated, there is some support for the view that the constitutional limitation on State initiative has sometimes interfered with desirable State cooperation in the United States. It is interesting to note that comparable provisions are not found in the legislation creating the federal governments of the various British dominions, nor in the German Constitution.

(2) *Inflexibility.*—Interstate compacts are in the nature of contracts, and modifications are likely to be quite as difficult to arrange

[14] In 19[illegible], Congress withheld approval of the Connecticut and Merrimac River compacts negotiated under the Flood Control Act of 1936 because the Federal Power Commission believed the compacts went beyond the purpose of that act and the established Federal policy with respect to water-power resources (Council of State Governments, Book of the States, 1941-42, p. 56).

[15] Book of the States, 1941-42, p. 56.

[16] Ernest C. Carman, "Should the States be Permitted to Make Interstate Compacts Without the Consent of Congress," Cornell Law Quarterly, February 1938, pp. 280 ff.

[17] In 1938, the Supreme Court remarked in *Hinderlider, State Engineer v. La Plata River and Cherry Creek Ditch Company* (304 U. S. 92, 109), that assent of Congress to a compact does not make it a "treaty or statute of the United States" and reviewable by the Supreme Court on appeal (Book of the States, 1941-42, p. 56).

[18] These provisions are as follows:

United States.—"No State shall, without the consent of Congress, * * * enter into any agreement or compact with another State * * *" (art. I, sec. 10).

Switzerland.—"All separate alliances and all treaties of a political character between the Cantons are forbidden. On the other hand the Cantons shall have the right to make conventions among themselves upon legislative, administrative, or judicial subjects; in all cases they shall bring such conventions to the attention of the Federal officials, who are authorized to prevent their execution, if they contain anything contrary to the Confederation, or to the rights of other Cantons. Should such not be the case, the contracting Cantons are authorized to require the cooperation of the Federal officials in carrying out the conventions" (art. 7).

Mexico.—"The States may fix among themselves, by friendly agreements, their respective boundaries; but such agreements shall not be carried into effect without the approval of the Congress of the Union" (art. 110). "The States shall not in any case have power (1) to enter into alliances, treaties, or coalitions with another State * * *" (art. 111). (Articles 116 and 117 of the 1917 Constitution).

Argentina.—"With the knowledge of the Federal Congress, the Provinces may enter into partial treaties for the purpose of the administration of justice, and regulation of financial interests, and the execution of public works of common utility; * * *" (art. 107).

Brazil.—"The States shall have power (1) To conclude among themselves agreements and conventions of a nonpolitical character" (art. 65). "To the President of the Republic shall belong the exclusive right (16) * * * to approve those [treaties and conventions] made by the States in conformity with article 65 * * *" (art. 48). This does not appear in the 1937 Constitution.

[19] R. C. Brooks, Government and Politics of Switzerland, World Book Co., New York, 1920, pp. 342-343.

as the original agreement. Some account of this problem may be taken in the original compact, such as the delegation of certain powers of decision to a responsible authority. At best, the inflexibility factor remains formidable. It is for this reason that the conclusion is often drawn that compacts are only adapted to issues capable of a once-and-for-all settlement.

(3) *Enforcement.*—Interstate compacts resemble international treaties in many respects, one of which is that enforcement rests on moral obligation only. These gentlemen's agreements contemplate no congressional action for their enforcement and the Federal courts are powerless to act.

(4) *Scattered States difficult to bring together.*—Compacts have usually involved small numbers of contiguous States, and would be difficult to negotiate where the issue involves many, and perhaps scattered, States.

(5) *Adaptation to social and economic issues difficult.*—Because of several of the above limitations, the use of compacts in the solution of interstate economic and social problems, including those directly pertaining to taxation, has never been and probably never can be of great importance. Because of reluctance of States to place contractual limits on taxing power, compacts in the tax field would be largely confined to means of compelling compliance in the case of interstate complications and other administrative matters.[20] Even here, administrative cooperation may be more expeditious. Other machinery must be found or devised for this class of problems.

3. PROMOTION OF UNIFORMITY IN STATE LEGISLATION

Opinion differs as to the extent to which social and economic uniformity in the United States accompanies a very considerable diversity of physical conditions. And opinion differs as to what extent uniformity in State legislation would be desirable. But most of the critics have agreed that a considerably greater degree of uniformity than that now existing would be desirable, at least in certain fields of legislation. They point to the variety of traffic rules as impediments to travel and commerce; to the variety of business regulations and tax obligations as restrictive of economic development and responsible for high compliance costs, and to the competition of the States through easy marriage, divorce, incorporation, and tax laws as undermining the maintenance of standards.

Some uniformity has been achieved easily by the process of copying legislation, a practice which is quite common. The other principal influence toward uniformity, outside of federalization and grants-in-aid, discussed later, is exhortation by organized groups and some facilitation through the formulation of so-called model statutes.

Among the organizations which have devoted considerable energy in the promotion of uniformity are: The National Safety Council, the American Automobile Association, the American Association for Labor Legislation, the American Public Welfare Association, and the National Tax Association.[21]

Of a more official nature, and perhaps most outstanding of all, is the National Conference of Commissioners on Uniform State Laws.

[20] Mark Graves, "Tax Compacts," State Government, vol. 9, January 1936, p. 15.

[21] Rodney L. Mott, "Uniform Legislation in the United States," Annals of the American Academy of Political and Social Science, vol. 207, January 1940, p. 81.

This was formally organized in 1892, but may be said to have originated with the founding of the American Bar Association (1878), with which it has always been quite closely related.[22] The Conference has held meetings since its organization, and since 1912 all States have been officially represented. The Conference operates through the careful and deliberate formulation of model laws and the subsequent promotion of State adoption of these laws. Greatest success has attended the promotion of uniform laws relating to commercial regulation and legal procedure. Thus a model negotiable instruments act has received nearly universal adoption, and acts dealing with desertion and nonsupport, bills of lading and warehouse receipts, narcotic drugs, fraudulent conveyance, and civil procedure, have been widely accepted. Some disappointment is expressed over the degree to which some of the acts promoted by the Conference and accepted by the States have been modified by subsequent State legislation or diverse interpretations by the courts. Also, it has not been easy to interest the average State legislator in the proposals of the Conference, although the Council of State Governments in 1940 commenced an active program of cooperation with the Conference to encourage legislative consideration of its acts. Here, as in the case of interstate compacts, the instrumentality appears ill-adapted to deal with social and economic problems where the subject matter is highly controversial. A uniform workman's compensation act was drawn by the Conference, but this subject was dropped from its agenda in 1932 and this and similar legislation received only very limited adoption. The Conference also drew a model State inheritance-tax statute with reciprocal features. As previously related, such legislation, with strong promotion outside the Conference, did gain considerable State attention and favorable action before a decision by the Supreme Court in 1932 seemed to make reciprocity no longer necessary.

Model State tax systems outlined by committees of the National Tax Association have attracted much attention. But they can hardly be said to have made any achievements in the direction of uniformity. Model procedure recommended by other committees of the Tax Association, such as the allocation formula used in State income-tax laws, can be said to have exercised a wholesome influence in the direction of uniformity.

4. RECIPROCAL LEGISLATION

A means of coordination by State legislation not requiring the approval of Congress is the passage of laws with reciprocal provisions. These laws are conditional in their application, the condition being that other States follow suit. In inheritance taxation they take the form of providing that the enacting State will not tax the intangible assets of residents of other States which offer similar immunity to the former's residents. As previously stated, such legislation had considerable vogue before 1932 (when a Supreme Court decision made it appear unnecessary), and it undoubtedly achieved some success in terms of uniformity and the elimination of multiple taxation. In insurance taxation, reciprocal (and retaliatory) provisions are common, but they appear to have achieved less uniformity than is sometimes

[22] Richard A. Girard, The Scope for Uniformity in State Tax Systems, special report No. 8, New York State Tax Commission, 1935, p. 28.

assumed. In motor-vehicle taxation, onerous burdens on nonresidents have been considerably curtailed by the process of trading and bargaining through reciprocal legislation and by conference. In income taxation, a number of States provide immunity or credits for nonresidents on a reciprocal basis.[23] This eliminates some multiple taxation but has insufficient adoption to make a significant contribution to uniformity. The reciprocal-legislation tool is a useful one to have, and its use and extension can be given unqualified endorsement, but past experience with it demonstrates that it is no easy road to uniformity and elimination of multiple taxation.

5. STATE AGENCIES FOR INTERSTATE COOPERATION

(*a*) *Cooperating agencies.*

Voluntary association to promote intergovernmental cooperation has been considerable and it has achieved some success. No careful student of State government has failed to notice the extensive activities of the former American Legislators' Association, and the present Council of State Governments, and also the National Association of Tax Administrators affiliated with the Federation of Tax Administrators. On the municipal front there are perhaps equally prominent organizations, among which are the National Municipal League, the American Municipal Association, the United States Conference of Mayors, and the Municipal Finance Officers Association.

(*b*) *The Council of State Governments.*[24]

(1) *Origin and purpose.*—The Council of State Governments evolved from the American Legislators' Association founded in 1925. That association held its first interstate assembly in 1933, and established the important Interstate Commission on Conflicting Taxation and other interstate commissions. The Council of State Governments was under discussion and planned in 1933, and assumed its present name, expanded functions, and status as a completely organized autonomous body in 1935. This more comprehensive organization was created by the official legislative action of 35 State governments.

The Council of State Governments is a joint governmental agency to serve the States. It operates as a secretariat for the Governors' Conference, the American Legislators' Association, the National Association of Attorneys General and the National Association of Secretaries of State. It serves as a clearing house and research center for legislators, legislative reference bureaus, State administrators, and the organizations mentioned above. It also works in close cooperation with the National Conference of Commissioners on Uniform State Laws. This latter organization, after half a century of effort in the field of uniform laws with only modest success, decided in 1940 to utilize the machinery of the council for stimulating and effecting the passage of legislation.

A primary purpose of the Council is to devise and install machinery by which States can reach agreements and cooperate with each other

[23] Clarence Heer, "Reciprocity—A Critical Appraisal of Its Possibilities," Proceedings of the National Tax Association, 1940, pp. 350-363.

[24] The bulk of the information in this section, based mainly on a memorandum prepared for this study by Russell Hinckley, was obtained from: Council of State Governments, The Book of the States, 1935, 1937, 1939-40, 1941-42, Council of State Governments, Chicago, Ill., and Temporary National Economic Committee, Investigation of Concentration of Economic Power, Hearings, pt. 29, March 18-23, 1940, Interstate Trade Barriers, 1941, pp. 15738-15756.

and with the Federal Government in legislation as well as in administration and planning. It is technically a medium through which interstate and Federal-State problems may be approached. It acts as a clearinghouse and forum for discussion of problems which overlap State boundaries, e.g., flood control, stream pollution, conflicting taxation, interstate truck regulations, trade barriers, highway safety, relief, social security and transiency, national-defense measures, liquor control. Reliance is placed on the device of compacts, uniform laws, and informal agreement and cooperation. The prime problems to be dealt with are those presumably too broad for any State, and for which Federal action alone is not suitable because of lack of constitutional power, because the problems are of regional or sectional rather than national interest, or because Federal action must be supplemented by cooperative State action.

Judging from statements of the officers of the Council, one may conclude that one of its purposes is to resist trends toward Federal centralization. The pressure for centralization in the New Deal era gave considerable impetus to this aspect of the movement. For instance, it has been stated by spokesmen for the Council that—

> There is only one way in which we can reduce the pressure for Federal centralization, and that is by devising effective machinery through which the State governments can harmonize their policies and their practices, and engage in a constructive and aggressive campaign of cooperation for better, modern, integrated government.[25]
>
> It is probable that unbiased political scientists could agree on this basic philosophy of government: whenever a function can be satisfactorily exercised by a State government, it is better that it should be exercised by a State government, and not by the Federal Government.[26]

This characteristic of a defensive alliance against Federal centralization is not unenlightened in the sense that it is mere reiteration of the States' rights dogma—it involves constructive efforts toward increasing State competence.

The Council publishes a biennial yearbook, *The Book of the States*, a monthly magazine, *State Government*, and a weekly *Digest of Opinions* for the National Association of Attorneys General.

(2) *Organization*.—The individual State commissions on interstate cooperation, which have had some 6 years of progressive development, are the component parts of the Council from which it derives its existence and authority. The commissions are established by the State legislatures, and are currently (1942) reported to be organized in all States. Five States participated in 1935, 13 States in 1937, 37 States in 1938, and as of April 1941, the Book of the States reported 44 State cooperation commissions. Of the 44 commissions, 41 had been created by legislatures and 3 by executive action pending statutory authorization. At that time, only Arizona, Idaho, North Dakota, and Washington did not have commissions, but appointments were expected. According to the Council's model bill for State organization, the typical commission comprises 15 members: 5 appointed by the speaker of the house from that body, 5 by the president of the State senate from that body, and 5 administrative officers appointed by the Governor, usually from his cabinet. One of the latter officers usually acts as chairman. The legislative members represent standing committees in their respective houses on the subject of interstate

[25] Henry W. Toll (executive director), "The Federal System," State Government, vol. 8, No. 11, November 1935, p. 22.
[26] Ibid., p. 219.

cooperation. Some States vary this pattern. In Kentucky and Kansas, the commission is the legislative council; in New York, 17 members are appointed by joint resolution each year. In 3 States, there are 9 members; and in Tennessee, 5 appointed by the Governor. In Texas the body is a joint commission, the Governor and attorney general each making appointments.

The State commissions initiate action in fields where there appears to be need for activity to benefit the States of the area, and often request the Council to take action, arrange conferences, and set up interstate commissions of regional or nation-wide scope. In the defense period, the State commissions took steps to cooperate in and meet State and local defense problems, and many served as legislative committees to State defense councils. In a number of regions, when groups of States have special problems requiring continuous attention, special interstate commissions have been created with their own headquarters. These are often composed of members of the State commissions appointed by the chairmen of the cooperation commissions or by the Governors.

The State cooperation commissions vary in activity and quality of work, almost in proportion to the funds available and the use of an executive secretary or staff. The most notable efforts and interest have been achieved in New York, Illinois, Indiana, Massachusetts, New Jersey, and Pennsylvania. Legislative appropriations to the commissions have ranged from $30,000 a year in New York to $200 in Vermont. In 1939, 15 States had appropriated $96,600 to their commissions. In other States, expenses were paid out of legislative travel and contingent funds.[27] Regardless of relative activity and appropriations, however, the machinery is present for introduction of legislation along lines developed by Council activity.

Every State appropriating funds in any year to the council is entitled to a representative on the board of managers for that year. The board also has serving on it as managers-at-large, or ex officio, other outstanding government officials. The State representatives are chosen by the State cooperation commissions. The ex officio members are the 5 members of the executive committee of the Governors' Conference; the presidents of the National Conference of Commissioners on Uniform State Laws, the American Legislators' Association, the National Association of Attorneys General, and the National Association of Secretaries of State; and the executive director and honorary president of the Council of State Governments. To obtain continuity and retain valuable members who may change the official positions by virtue of which they are board members, 10 managers are elected at large for staggered terms of 10 years.

The executive committee of the board of managers consists of a president (a State Governor); a first vice president (a State legislator, who serves as chairman of the board); two vice presidents; an auditor (a State fiscal officer); and the honorary president and the executive director.

The general assembly of the Council of State Governments meets every 2 years in a forum type of conference scheduled to coincide with the opening of the 43 State legislatures which convene in January of odd years. It draws representatives from legislators and State

[27] Hubert R. Gallagher, "Work of the Commissions on Interstate Cooperation," Annals of the American Academy of Political and Social Science, vol. 207, January 1940, p. 104.

officials. Each cooperation commission is represented by at least one senate member, one house member, and one administrative officer, and many Governors also attend. The timing permits legislative action on any program worked out and discussed and taken back to their States by the delegates. The cooperation commissions, associations of governmental officials, and special commissions and committees report and make recommendations at this session.

The subjects of the sessions are developed in conformity with contemporary problems of interest. In 1933, 105 delegates from 39 States considered conflicting taxation and created the Interstate Commission on Conflicting Taxation. In 1935, 153 delegates from 41 States discussed taxation and created the present Council of State Governments. In 1937, 250 officials from 45 States discussed interstate relations, social security, crime control, etc. In 1939, delegates from 46 States discussed State implications of Federal financial programs and the Council's program of cooperation, State administrative reorganization, and trade barriers. In 1941, 308 delegates from 46 States heard reports on defense, relief grants, and taxation.

(3) *Finances of the Council.*—At the outset, the Council was almost completely supported by private philanthropic funds, namely, the Spelman fund and a small contribution from the Rosenwald fund. Annual reports of the Spelman fund [28] show that from 1930 on substantial grants have been made to the American Legislators' Association and the Council. The grants have varied in amount: $74,000 in 1929–30, $86,000 in 1931, $3,000 in 1932, $120,000 in 1933, $22,000 in 1934, $170,000 in 1935, $42,000 in 1936, $95,000 in 1941, etc. State support has increased over the years, with more and more States participating. The State contributions are not made in accordance with any fixed formula, and the States also vary widely in the support they give their cooperation commissions.

From 1930 to 1936, bills were introduced at almost every session of Congress seeking an appropriation of $40,000 toward the legislative reference service and other activities of the American Legislators' Association.[29] A $25,000 Federal appropriation was also sought from 1935 to 1937 to match Spelman funds for the work of the Tax Revision Council of Federal, State, and local membership to deal with the fiscal coordination question. From 1937 to 1939, bills were introduced in Congress to appropriate $150,000 for the work of the Council of State Governments. These bills would have authorized Federal agencies to use the facilities of the Council in promoting State cooperation and legislation in support of Federal programs in labor standards, agriculture, education, health, and welfare. Such bills were introduced by Senator La Follette and Representatives Secrest, Voorhis, and Celler.[30]

In 1937 the Council indicated that its budget should total about $150,000, and the third assembly recommended that this sum be distributed among the States according to percentages of national wealth and income and the number of registered voters. New York's share would have been $20,000 according to this scheme.[31]

(4) *Relations with the Federal Government.*—The Council has continually requested Federal agencies to use its machinery rather than

[28] Spelman Fund of New York, Reports for 1930-36 and 1940-41.
[29] H. J. Res. 156, 74th Cong., 2d sess., February 5, 1935 (Mr. Secrest); H. J. Res. 481, 74th Cong., 2d sess., February 5, 1936, etc.
[30] Cf. S. J. Res. 182, 75th Cong., 1st sess., July 22, 1937 (Senator La Follette).
[31] Book of the States, 1937, vol. II, book I, Chicago, 1937, pp. 34-35.

to pursue an independent course of contacting the States. The Interstate Commission on Conflicting Taxation prepared one of the few important reports on the tax coordination question. It contacted congressional committees, the Joint Committee on Internal Revenue Taxation, and administrative officials, and elicited favorable response from Chairman Harrison of the Senate Finance Committee and Chairman Doughton of the House Ways and Means Committee. Through its activities, the Interstate Commission arranged the first comprehensive intergovernmental meetings on the subject of fiscal coordination.

Another attempt by the Council to further Federal-State-local fiscal coordination was the Tax Revision Council, which the Council of State Governments sponsored and offered to help finance. The Tax Revision Council, on which all three levels of Government were represented, did not receive Federal funds, and its activities were suspended after a few meetings were held.

The Advisory Commission to the Council of National Defense used the Council's facilities in defense organization. In the passage of national-defense law-enforcement measures, the Council and its organizations cooperated with the Department of Justice. The Council's major achievement in spotlighting the interstate trade-barrier problem, by its national conference in 1939, involved cooperation with the Departments of Agriculture, Labor, State, and Commerce, the United States Marketing Laws Survey, Public Health Service, Federal Alcohol Administration, and National Resources Planning Board.

The Council's Special Committee on Relief contacted the Social Security Board, Work Projects Administration, and Farm Security Administration in development of its report on a welfare and public works-grants program. The Special Committee on Taxation conferred with the Treasury and Federation of Tax Administrators in 1941, endorsed the Treasury's recommendation for a special tax commission, and continued to call for tax coordination and to press for action in Congress. The fifth general assembly of the Council in 1941 also endorsed the Treasury proposal for a special tax commission.

In 1940, the executive committee of the Council, through the director, Frank Bane, suggested to the Temporary National Economic Committee [32] the formation of a continuing Committee on Federal-State Relations consisting of Congressmen and administrative officers cooperating with the Council of State Governments. This committee was visualized as making recommendations on trade barriers and extending its activities later to other fields of Federal-State relations, including taxation, grants, and transportation. This proposal was endorsed in general by Dr. W. Y. Elliott, of the Harvard School of Government, and was endorsed as to the trade barrier question by Henry A. Wallace, Secretary of Agriculture.[33] Paul Truitt, of the Department of Commerce and the Interdepartmental Committee on Trade Barriers, also endorsed the plan for a Federal-State Committee.[34]

(5) *Results of the Council's activities.*—Probably the greatest single achievement of the Council has been in respect to the interstate trade-barrier question. Through its 1939 national conference, wide publicity, and the work of the State cooperation commissions, additional

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[32] Temporary National Economic Committee, Investigation of Concentration of Economic Power, Hearings, March 18-23, 1940, pt. 29, Interstate Trade Barriers, 1941, p. 15751.

[33] Ibid., pp. 16091, 16114.

[34] Paul T. Truitt, "Joint Federal-State Attack Upon Trade Barriers," Tax Barriers to Trade, Tax Institute, Philadelphia, 1941, pp. 315-316.

barrier legislation was prevented and a few laws repealed. Wide consciousness of the problem was created and a trend arrested, but there was no general elimination of the offending legislation on the books. The New York State Tax Commission, in its 1939 annual report, considered the Council's work in this field effective and efficient.[35] The National Association of Accredited Publicity Directors awarded its annual medal in 1939 to the president of the Council of State Governments for the most outstanding job done in the interest of the general public during that year, namely, the trade-barrier campaign.[36]

Despite the machinery created in the Tax Revision Council, the effort previously mentioned to solve Federal-State conflicts in taxation brought no positive results. The proposals of the Interstate Commission on Conflicting Taxation were generally adopted by the second assembly and also received congressional acknowledgment, but resulted in no action. In the field of interstate tax cooperation, the activities of the Council per se have thus far met with little success. Some of the State cooperation commissions, however, have been quite active. The New York and Pennsylvania commissions have actively promoted interstate administrative cooperation, and the Eastern States' regional tax committees on domicile in estate taxation also have a record of action.

Considerable progress was made in promoting passage of uniform law-enforcement provisions for defense purposes. More limited results have been achieved by the interstate commissions on social security, the Ohio Basin and Potomac River Basin, the interstate conference on truck problems, regional conference on dairy problems, liquor control, highway safety, etc. The Ten-State Highway Conference has dealt with such matters as uniform size and weight regulations and model acts for transportation of inflammable liquids.

The Delaware, Potomac, and Ohio River Commissions, and similar bodies, though slowly progressing, are often held up by the compact process and the fact that success of the venture can be thwarted by action of a single State. The Council has also been participating in the International Board of Inquiry on Great Lakes Fisheries, another type of activity involving slow progress. It has also been called in to work on the Indiana-Kentucky and Kansas-Missouri boundary disputes.

Representative T. V. Smith, of Illinois, has said of the Council:

> It has sought to keep alive the pride of the States in meeting their own internal problems. And it has sought particularly and conspicuously to increase State competence in handling the multitude of problems that continually arise in the no-man's land between the States * * *. The Council of State Governments is determined that the question of differential expense and friction is not to be settled by negligence and default.[37]

Another recent critic offers this high praise for the Council and its subsidiaries:

> Probably the Council of State Governments and the organizations with which it works have contributed more, in proportion to their resources, to the effective reform of our system than any group dealing with any level of government.[38]

Whether or not one shares the view of these critics, one can readily agree that the Council has done very valuable pioneering work and

[35] State of New York, Annual Report of the State Tax Commission, 1939, p. 28.
[36] Letter from Frank Bane, executive director, Council of State Governments, March 14, 1942.
[37] T. V. Smith, "States' Rights and the Rights of the States," State Government, vol. XIII, No. 2, February 1940, p. 33.
[38] G. C. S. Benson, The New Centralization, New York, 1941, p. 144.

has achieved a degree of State recognition that makes it of unquestioned value in the movement to build a satisfactory institutional set-up for future Federal-State relations.

(c) *The role of coordination in a Federal system.*

An ideal Federal system in our modern era contemplates a group of semi-independent democracies, held together by a constitution and a common tradition, and functioning smoothly through a statecraft that includes a large factor of cooperation. This cooperation must be partly in the field of interstate and partly in that of Federal-State relations. The true spirit of the Federal system is sustained by efficient voluntary relationships which make compulsions of the unitary state unnecessary. The Federal Government must be a partner in this cooperative interplay in more ways than one. It must be a direct partner, of course, in Federal-State cooperation which must go hand in hand with interstate cooperation; it can assist the States in their efforts to work together; and it should assume the role of arbitrator in interstate conflicts (as in tax jurisdiction) where it is in the most strategic position to balance opposing interests. (The double-domicile fiasco in the inheritance-tax field is an example of the wide-open gaps that exist in the present operation of our federal system.) The techniques and machinery of government which we have inherited from the past were adapted to an economy and a fiscal system in which cooperation could be minimized without critical damage. But cooperation is the lubricant which, under modern conditions, makes a federal system go. To develop enough of this lubricant to keep the machinery moving smoothly in the still more interdependent economic era that lies ahead is a major challenge.

6. REGIONALISM AND THE TENNESSEE VALLEY AUTHORITY

(a) *Reasons for the development of regionalism.*

For many years, but particularly since the New Deal, there has been considerable speculation about the need for regional development traversing State lines. The traditional machinery of government at the State level has received considerable criticism. First, it is said that the States do not represent geographical, social, or economic unities. They are impotent to deal with problems which cover several States, and there are an increasing number of such problems. Secondly, it is contended that the States do not function effectively even within their own sphere. It is said that they were "dead on their feet" during the thirties and unable to supply initiative in such fields as unemployment, public-utility regulation, and conservation. In this connection it will be recalled that the States have a "rotten borough" system of representation. In 21 States, the largest part of whose population is urban, not one has an equitable representation system.[39] The gross underrepresentation of cities in some cases extends to both houses, and in a few instances it is crystallized in State constitutions. States have also been criticized because of the election system as applied to their administrative officers, and the size, low pay, and restricted sessions of many State legislatures. One writer castigates the States with the remark that "It all comes to this, that the States are so corrupt and incapable that the people

[39] G. C. S. Benson, op. cit., p. 119.

turn from them in disgust when they feel the need of government." [40] Thirdly, the States are said to impede, rather than facilitate, the satisfactory performance of services by municipalities. Professor Merriam presents this latter emphasis as follows:

Most States do not now correspond to economic or social unities, and their validity as units of organization and representation may be and has been seriously challenged. The Nation and the cities are vigorous organs, but the State is not, comparatively. Certainly as guides and guardians of cities, the States have been singularly ill-equipped and ill-qualified. Conceivably, States might be very useful to cities as administrative superiors, supervising such affairs as finances and police, but practically they have no such functions as a rule, and it does not seem probable that they will in the near future, so far as metropolitan regions are concerned.[41]

Not much can be quoted to rebut this indictment, but several observations may be made. The first is that the States are a historical fact and are likely to continue as a very important balance to Federal centralization for many years. Secondly, the States themselves may improve their record of performance, and in the interest of a well-balanced society they might well be exhorted to do so. Thirdly, the substitutes advocated to replace the States all have their limitations. The Federal Government itself could be and is heavily criticized. Corruption and incompetence at the Federal level cover many pages of any forthright American history. The picture as to administrative competence is quite mixed. For example, notwithstanding the above indictment, State administration in some States is far superior to that of most of the subdivisions. There is under these conditions a tendency for citizens to appeal to the State capitol to help them in controlling their own local officials.

One of the substitutes proposed to replace the States is what has vaguely been called regionalism. Not all the proponents of regionalism, however, envisage their goal as antagonistic to the States or as in any way limiting the latter. Rather, the movement would enlarge the usefulness of the States. At any rate, a very considerable interest and some action has developed in the field of regionalism.

(*b*) *Definition and kinds of regionalism.*

A major difficulty for the regionalists is the problem of defining regions. There are no clear-cut regional boundaries, at least not for all purposes, and all territories represent more or less criss-crossing of activities and interests. The leading work on regionalism [42] gives the following descriptions of types and patterns of regions:

The best picture of the Nation today in terms of river valleys is that which has been presented by the National Resources Committee through its special studies of drainage basin problems and programs. It constitutes an extraordinary picture of the Nation in terms of natural valley regions as well as an inventory of the problems and the potentialities of the multiple and rich natural resources as found in the rivers of the Nation and the natural regions created by them. The total picture is envisaged through 17 river valley regions, which in turn comprehend approximately 100 sub-river valley regions, which again comprehend a thousand tributaries, many of which include among them the most beautiful as well as the most significant streams in the Nation.

* * * The Nation has already been divided into numerous regions of many and varying purposes. There are regions of earlier historical significance. There are regions of newer administrative functions. There are regions of convenience

[40] Henry J. Ford, cited by W. Kollmorgen, "Political Regionalism in the United States—Fact or Myth," Social Forces, vol. 15, October 1936, p. 114.

[41] "Metropolitan Regions," an address delivered at the University of Chicago, March 20, 1928, found in the University Record, April 1928. Quoted by W. Brooke Graves, "The Future of the American States," American Political Science Review, February 1936, p. 25.

[42] Howard W. Odum and Harry E. Moore, American Regionalism, Holt, New York, 1938, p. 90.

and of necessity. There are regions of government and regions of commerce. There are regions of literary achievement and regions of agricultural adjustment. There are regions of land and of water, of forests and of minerals, of flora and of crops. There are regions of educational institutions and football arrangements; regions of wholesale trade and of Rotary and Kiwanis. There are regions within regions, subregions, and districts. * * * [43]

The authors go on to classify five types of regions as follows:

* * * first, the natural region, such as mountain range, river valley, great plains; second, the metropolitan region, where the city is the center and focus of the radiating territory adjacent; third, a general loosely used designation which implies the section or provincial locality from which loyalties, patriotism, folkways radiate; fourth, the region for convenience, such as administrative divisions of natural organizations or governmental departments; and fifth, the group-of-States region, which, if State lines be primarily the arbitrary margins of measurement, may comprehend in varying degrees most of the other types.[44]

In spite of the difficulties, however, the National Resources Committee attempted several divisions of the Nation into regions. One of the most plausible and promising divisions covered the country in 12 regions. Odum and Moore reduced the number to 6 major regions, which they found—

without doubt qualify as composite societal regions in which may be found for our purposes, the largest possible degree of homogeneity, measured by the largest number of indices available for the largest number of practical purposes.[45]

Of particular importance for the present study are regions classified on the basis of metropolitan influence, drainage-basin area, and special-problem districts.

(1) *Metropolitan regions.*—With the shift from a predominantly rural to an urban economy, accompanied by the growth of satellite industrial and suburban developments around major urban centers, there have appeared on the American scene what may be defined as metropolitan regions. The areal extent of these regions is often measured by circulation of metropolitan newspapers, wholesale and retail trade areas, livestock market areas, etc.

The 1930 census defines a metropolitan district as an urban unit "having an aggregate population of 100,000 or more, and containing one or more central cities of 50,000 or more inhabitants." [46] Ninety-six such districts are listed. A functional classification would give a much shorter list; 18 to 20 major metropolitan regions seem to be the most useful classification.[47] These regional classifications are useful, particularly as guide lines for urban rehabilitation programs and as possible regional units for administrative decentralization of various Federal agencies.

(2) *Drainage-basin regions.*—Some of the most promising attempts to arrive at useful regional classifications have been drawn up on the basis of drainage-basin areas. Within these regions there is a wide range of fairly homogeneous problems demanding coordinate, multiple-purpose treatment. Flood control, domestic water supplies, water for industrial uses, water pollution and sanitation, water power, fishing for recreational and commercial purposes, erosion, forestry, and soil

[43] Ibid., p. 5.
[44] Ibid., p. 29.
[45] Ibid., p. 618.
[46] Fifteenth Census of the United States, "Metropolitan Districts, Population and Area," p. 6.
[47] See Robert E. Dickinson, "The Metropolitan Regions of the United States," Geographical Review, 1934, pp. 278–291.

conservation all are interrelated aspects of the drainage-basin water-use control problem.[48]

Only in the Tennessee Valley has an action program been designed which attempts to solve this maze of river-valley problems. Proposals have been laid before Congress for similar developmental programs in 10 other watersheds of the nation.

The usefulness of the drainage basin as a field for multiple-purpose regional-investment programs has often been questioned. It is pointed out that even the drainage basis is far from a self-contained unit, and that many of its problems transcend any possible regional delineation and often have nothing to do with water-control and use problems. Where water-use problems are of central importance, however, the technique, if kept flexible, appears to be sound. That the line of appropriateness is difficult to draw cannot be denied.[49]

(3) *Special-problem areas.*—A regional approach is often useful in dealing with special problems or projects requiring interstate cooperation. The size and make-up of the regional organizations will differ according to the areal extent and nature of the project or problem involved—from a port authority or interstate bridge commission to a regional organization including a large number of cut-over States.

(c) *Forms of regional development.*

The movement toward regionalism has taken several forms. To begin with, the departments of the Federal Government have decentralized their administration into many regional units (about 80 percent of Federal employees are now located outside of Washington). However, each agency follows its own pattern of regionalism and sometimes follows a different pattern for the same function within the same department (for example, the Federal Reserve bank regions do not correspond with the regions of the Federal land bank). More than 100 plans of division of the country into administrative units have been discerned and mapped. In spite of this lack of correlation among boundaries, headquarters are often set up in the same city. For the year 1935, the following cities had the largest number of regional headquarters: San Francisco, 73; New York, 69; Chicago, 66; Boston, 48; New Orleans, 38; Denver, 37; Atlanta, 37; Twin Cities, 36.[50] The National Resources Committee and others have recommended an effort to simplify and integrate these Federal administrative districts (many of which are more or less arbitrary), although it is recognized that different functions require different patterns and that the possibilities of harmony are limited.

A second movement toward regionalism is that in the field of planning. Here the activities of such semiofficial regional organizations as the New England Regional Planning Commission, an outgrowth of the older New England Council, and the Pacific Northwest Planning Commission are noted. Also the planning efforts of six interstate metropolitan regional-planning organizations centering in Washington, D. C., New York City, Philadelphia, Chicago, St. Louis, and Kansas City, have attracted considerable attention. The New York

[48] David W. Robinson, "Voluntary Regionalism in the Control of Water Resources," Annals of the American Academy of Political and Social Science, vol. 207, 1940, p. 116.

[49] For some discussions of this question see National Resources Committee, Regional Factors in National Planning, Washington, 1935, p. 111.

[50] J. W. Fesler, "Federal Administrative Regions," American Political Science Review, vol. 30, April 1936, p. 265.

region includes 22 counties in New York, New Jersey, and Connecticut, "all that territory in which people's ways of living and working are directly affected by the presence of the metropolis."

Finally, and most important of the developments in regionalism, there is the Tennessee Valley Authority. This was designed not only to meet the needs of regional development transcending State lines but also as an experiment with a new kind of machinery, the Government corporation "clothed with the power of Government but possessed of the flexibility and initiative of a private enterprise." [51] The Tennessee Valley Authority was given a wide range of functions including water control, power development and utilization, fertilizer production, agricultural and industrial development, afforestation and soil erosion, land planning and housing, social and economic research.

(*d*) *Experience with the Tennessee Valley Authority.*

No attempt can here be made to relate the history or appraise the results of the Tennessee Valley Authority. Suffice it to add that many of the proponents of the experiment have acclaimed it as establishing a procedure which may be confidently applied to the whole country. President Roosevelt on one occasion suggested to Congress that there be established at least six additional river valley regional planning agencies in the Nation. The regions suggested include the Atlantic seaboard, the Great Lakes-Ohio Valley, the Missouri Valley, the Arkansas Valley, the Southwestern, and the Columbia Valley. This represents a consolidation of 17 major river valleys described in the report of the special committee of the National Resources Committee.[52] However, the National Resources Committee expressed some doubt that river basins should be universally adopted as regions for planning and development.[53]

Of the Tennessee Valley Authority it can be said that it has proved a means by which congressional authority over navigable streams has formed a ready ingress to performing a variety of needed functions. The usefulness of this experience for post-war public work will be considered later. While the experiment opens up a trend toward new governmental structure, it need not be concluded that such developments weaken or undermine the States. The program calls for cooperation of all the existing agencies of government, rather than debate as to the status of these agencies. The States retain most, if not all, of their traditional functions and it is a large enough sphere of sovereignty to warrant the investment of much more civic interest than has hitherto been manifested.

(*e*) *Intergovernmental relations of the Tennessee Valley Authority.*[54]

The regional technique requires more far-reaching and successful intergovernmental cooperation than does any other action-program device developed by the Federal Government. It is in this aspect of its work that the Tennessee Valley Authority seems to have contributed most to the planning of the future public-investment program.

Early in its history, the Authority recognized the necessity of gaining the confidence and cooperation of the valley people, their institutions, and their government agencies. There is substantial evidence

[51] National Resources Committee, Regional Factors in National Planning, 1935, p. 83.
[52] Ibid., p. 171.
[53] Ibid., p. 170.
[54] Based on a monograph prepared for this study: William Oates, Implementing a Post-War Public Investment Program.

that this cooperative aspect of the venture has been successfully carried out—not only providing efficient administration of the action programs, but actually strengthening and revitalizing local government units.[55]

The relationships have taken a number of forms: [56] (1) Exchange of data, information, and advice, (2) the written agreement, (3) the gentleman's agreement or mutual cooperative understanding, (4) direct cooperative joint committees and conferences, (5) exchange of personnel, and (6) financial assistance.

An examination of some of the problems and cooperative efforts at solution gives an interesting insight into Tennessee Valley methods.

(1) *The problems growing out of condemnation of land for reservoir and power projects.*—Large-scale condemnation of land necessary for reservoir and power projects has raised a number of problems—highway relocation, school relocation, community planning, and loss of tax base. In each of these fields solutions have been worked out by cooperative action of the agencies affected.

Highway relocations, made necessary by the flooding of roads in reservoir areas, have been jointly planned by the Authority and State and local governments. In each case the adjustments have been designed to fit into the broader pattern of State and regional highway use.[57]

The same projects have necessitated purchase by the Authority of many one and two-room local schools, as well as the shifting of the school population involved. In the resulting readjustment local school systems have been replanned and substantial consolidation of school districts accomplished.

The construction of dams and reservoirs has given rise to many planning problems in valley communities. Municipal planning commissions have been set up in some twenty reservoir-affected districts, and are aided in their work by technicians from the Authority. The local commissions usually have been given wide powers over use of property in the community, and are cooperating with the Authority in land-use decisions for the areas around the town borders.[58]

Land for its multiple-purpose projects has been acquired by the Tennessee Valley Authority in 111 counties. This presented serious local-revenue problems, since tax bases were undermined and any tangible benefits of the programs were in the distant future. After cooperative study it was agreed to increase the percent of the gross proceeds from the sale of power that was paid to States and localities in lieu of taxes. As a result, each State and county is paid a minimum amount "equal to the former property taxes on property purchased by the Authority." [59]

(2) *Sale of power to local agencies.*—States and localities have passed a substantial amount of legislation to facilitate the distribution

[55] This conclusion is supported by the following: Lawrence Durisch, "Local Government and the Tennessee Valley Authority Program," Public Administration Review, vol. 1, No. 4, Summer, 1941, p. 327; C. L. Hodge, The Tennessee Valley Authority—a National Experiment in Regionalism, Washington, 1932, p. 160; Anonymous, "Relation of the Federal Regional Authorities to State and Local Units," Annals of the American Academy of Political and Social Science, 1940, p. 133; Report of the Joint Committee Investigating the Tennessee Valley Authority, 76th Cong., 1st sess. S. Doc. No. 56, 1939, p. 89.

[56] This list is taken from Hodge, op. cit., p. 184.

[57] "Local Government and the Tennessee Valley Authority Program," op. cit., p. 328.

[58] Ibid., pp. 328-329.

[59] Ibid., p. 331.

of Tennessee Valley Authority power,[60] and contracts have been negotiated with 78 municipal and county systems for its distribution. The relationships established are often close ones, since the Authority endeavors to see that the local distribution system is on a self-sustaining basis.[61]

(3) *Cooperative health programs.*—Very extensive cooperation has taken place in the health field; the influx of population to Tennessee Valley Authority construction sites has created health problems that unaided local efforts could not meet. The United States Public Health Service works with the Authority and State officials in aiding counties to set up health and sanitation units. After completion of the construction project, the health units are turned over to county or State officers for complete operation and support, except in cases where the malaria problem is so serious as to require continued cooperative action.

(4) *Other joint activities.*—The Authority has cooperated closely with local agencies in meeting law enforcement problems, employees of the Authority being given enforcement powers by local government units. Joint studies are being carried out by the Authority and the Tennessee Valley Water Conference, representing municipalities on the river, to develop a unified system of public terminals.[62] The activities listed above are but examples. Some idea of the scope of the cooperative effort may be obtained from glancing over lists of cooperating agencies in a few of the Tennessee Valley Authority action fields.[63]

Even a hasty survey of the Tennessee Valley Authority's activities is sufficient to support the conclusion that much can be learned from its experience as to the value and techniques of intergovernmental cooperation.

B. Agencies and Instrumentalities of Fiscal Coordination

1. JOINT ADMINISTRATION

(a) Collaboration in administration.

Collaboration between Federal and State administrators is a prerequisite to the smooth functioning of any federal system, and it is quite extensive in our own. The field of tax administration is no exception. It is now possible for State tax officials to utilize Federal income-tax returns for information, and such services are available on tolerably economical terms for the States. The evidence indicates that some States have utilized this means of improving State administration quite extensively, and other States would be well-advised to utilize this cooperative privilege on a wider scale.

(1) *State use of Federal facilities.*—The development of Federal facilities and their use is worth relating in some detail.[64] Although the provision of Federal services to the States is commonly thought to be of recent origin, Commissioner Henry F. Long, of Massachusetts, was examining Federal tax returns for State purposes as early as 1920. In 1921 Massachusetts had a crew of 14 working in Washington for

[60] Regional Factors in National Planning, p. 100.
[61] "Local Government and the Tennessee Valley Authority Program," op. cit., pp. 329–330.
[62] Annual Report of the Tennessee Valley Authority, 1940, p. 3.
[63] The Tennessee Valley Authority—A National Experiment in Regionalism, p. 182.
[64] Based on a monograph by James W. Martin on tax administration prepared for this report; also on a statement prepared by Walter W. Heller.

2 months.[65] Legislation, as early as 1918, made available corporation returns only, and to the income-tax States exclusively. Congress first made general provision for State inspection of Federal returns in the Revenue Act of 1926,[66] and this was not adequately implemented until 1931.[67] Subsequent legislation, Executive orders, and administrative rulings placed a broad array of services at the disposal of income-tax States. Most income-tax States have taken advantage of these low-cost facilities. Especially during the thirties has the flow of Federal data to the States gained strength. Not all States have participated equally, however. Some have made scarcely any use of Federal information. The legal right under the extended application of the Federal law covers the privilege to inspect not only income-tax returns (corporate and individual) but also those for excess profits, estate, gift, pay roll, capital stock, and some of the minor taxes.[68]

Permission to inspect returns is obtained by governors' written applications addressed to the Commissioner of Internal Revenue. All such communications must set forth in elaborate detail specified information designed to insure that the desired inspections are regular. Usually, officials entitled to inspect returns may have access to schedules, lists, records, reports, information returns, and other supplementary materials. Copies of returns are furnished upon specific request and by payment of a fee of $1 plus 25 cents for each additional page of schedules and other materials. In actual practice, most States secure permission to examine returns of one or more classes. Some States use commercial photography (microfilm) processes and others rely on hand transcription to obtain copies of thousands of Federal returns. The Bureau has reordered files in such manner as greatly to facilitate photographing.

Only the Form 1040 individual returns (for incomes over $5,000 or from business, profession, rent, etc.) and corporation returns are kept in Washington. Form 1040–a returns (for incomes of simple composition not over $5,000) are retained in the 64 Federal collectors' offices. Although the States are allowed access to all original returns, it is only in the last few years that some of them have turned to the smaller and generally less productive returns in the district offices. With the recent lowering of the Federal exemption, Form 1040–a has been converted into an "optional return" for incomes under $3,000. In its new form, the return is so highly simplified that it will probably prove of very little value to State administrators.

By far the most significant formal Federal aid to State tax administration is the special transcript service established by the Bureau at only nominal expense to the States. It provides, through a combination of informal negotiation with the Records Division and formal approval by the Commissioner, for preparing transcripts of audit changes. This may be secured for any designated class of returns in any detail desired. The service is particularly valuable, largely

[65] Tax Administrators News, vol. 4, August 1940, p. 58.

[66] Revenue Act of 1926, sec. 257 (a) (c). In the Revenue Act of 1924, the restriction that information could be divulged only to income-tax States was removed (sec. 57; see also Congressional Record, vol. 65, pt. 3, p. 2961). In 1934 Congress required certain information contained in returns to be filed separately and made available for general inspection, and the Treasury authorized a form for this purpose (Revenue Act of 1934, sec. 55 (b), and Regulations 86, art. 55 (b)–1 to art. (b)–5). The Revenue Act of 1935 also required copies of income-tax returns (or the original) to be made available for State official use incident to tax administration generally (Costigan amendment: Sec. 55 (b) 2, Revenue Act of 1935). The Treasury after some years discontinued the use of green duplicates. Under the same statutory provisions, however, the original returns are made available for examination.

[67] Treasury Decision 4317, approved June 9, 1931.

[68] Internal Revenue Code, secs. 508, 511, 603, 604, 702–a, 706, 729, 938, 1031, 1204, 1294, 1604–c, 1858, 2482, 3413, 3462, etc.

because it is susceptible of such complete adjustment to the purposes of the State. Ordinarily, arrangements for the transcript service provide for supplying automatically data regarding readjustments in tax liability shown on particular classes of returns. Interested States receive such transcripts twice a month, and are billed for the clerical cost each month.

Twenty-three States regularly secure the transcript service and four others secure the substantial equivalent (through photostating returns after audit). Not all these States, however, use the transcript for all classes of returns. The records indicate that the service is strikingly inexpensive. For example, Kentucky pays about 9 cents apiece for summary transcripts, and Utah pays 10 cents each for complete transcripts. At the total cost for 34,504 transcripts of only \$3,299.41 [69] for the fiscal year ending 1941, it is surprising that all States do not utilize the service to the fullest possible extent. The service provides a method by which States get almost the full benefit of Federal audits. Kentucky, for instance, gets something like the equivalent of 20 auditors' work at a cost representing the salary of one investigator for less than a month.

The States are fitting this valuable resource into their programs in four distinct ways. Wisconsin and California are using the Federal audit abstracts chiefly as leads to audits of their own. Louisiana, Oregon, and Utah use the Federal data to supplement their own auditing work and thereby increase its coverage. States in a third group, including principally Kansas and Missouri, build their entire audit programs around the Federal audit results. And one or two States virtually substitute the Federal audit program for their own through the use of these transcripts. Whatever the degree of use, the advantages reaped are great in relation to the cost of the service.

The transcript service generously provided by the Commissioner of Internal Revenue thus represents the very best in formal intergovernmental cooperation.

Bureau policy toward State officials is still mainly formal, but the States as a whole are not taking full advantage of the opportunities which are afforded. Perhaps one reason for this rigidly conventional policy is the failure of some States to keep faith with the Bureau. The Bureau takes the attitude that it must keep faith with taxpayers and for that reason objects to States divulging the source of information with respect to Federal action. A few States have had to be reprimanded for their failure to cooperate.[70] The Bureau might relax formalities if it could in all instances be assured of reciprocal cooperation by the States. Certain Bureau practices, however, it has been alleged, point toward an uncooperative attitude. It would seem, for example, that the language of the Costigan amendment is broad enough to include local officials. The act provides for inspection by "any official charged with the administration of any State tax law." Local officials are in fact often engaged in administering State tax laws, but the Treasury has denied to them the right of inspection. By the circuitous route of securing the intervention of State officials for them, some cities have, nevertheless, obtained valuable information from this Federal source.

(2) *Interstate and Federal-State exchange of information.*—Exchange of information among State officials is also considerably developed and

[69] Quarterly Report of Activities, Records Division, Income Tax Unit, quarter ended June 30, 1942, p. 12.
[70] Interview with Bureau officials, June 1942; cf. Heller, op. cit., p. 246.

it has been a substantial factor in the improvement of State tax administration, particularly in the case of the gasoline tax and, to a lesser extent, the State excise taxes. As between the Federal Government and the States, exchange of information has been a rather unilateral affair. The States in some cases have information (and techniques), particularly concerning coverage in income-tax application, that should be useful to Federal authorities, and an effort should be made to secure Federal access to this information.[71] This is an example of the potentialities of *mutual* aid in administration.

Instances in which the Federal Government uses State records to advantage include the following: (1) In connection with excises on dealers, Federal agents are supplied lists of licensed dealers; (2) lists of corporations are provided by some States, notably New York and Delaware; (3) the States provide credit vouchers on every taxpayer contributing to State employment taxes; these are matched with Federal returns to discover delinquencies.[72]

(3) *Interstate cooperation in income taxation.*—Many State officials are aware of the escape from State income taxation of income received by corporations operating in more than one State. States are often powerless to prevent such escape, since they cannot see the tax returns made out to other States and rarely have sufficient funds to make a complete check on the corporate books. Hence, a given corporation, by emphasizing different factors in different States, can minimize the income allocable to any given State.

Two actions are needed to block the path to such tax evasion. The first is collaboration among State administrative officials to insure (*a*) that the figures reported for any given factor are the same in all States concerned, and (*b*) that corporations do not successfully claim special weight for one factor in one State, another in a second, and third in a third, each designed to minimize income in the taxing State.[73] Interstate administrative cooperation cannot do the whole job, but it will clearly expose the reason for its failure, namely, the lack of uniformity in allocation formulas (and the very broad administrative discretion which is partly presponsible for it). This lack may cause more than 100 percent of income to be included in State bases, but it is just as likely (and according to many State officials, more likely) to let some income escape tax-free. The second action needed, then,

[71] The Treasury might well make use of certain experience accumulated by the States. For example, the effective income-tax compliance activity in respect of low-income groups has been possible in some States because the State successfully utilizes local industrial and governmental sources of information. Information concerning salaries and fees of State and local officials which are not reported through regular information-at-the-source channels, might be obtained from State treasurers or comptrollers who often have accessible lists and records rarely published. State directories of professional persons, such as attorneys, physicians, dentists, parmacists, engineers, and accountants; State lists of licensees of various sorts, such as barbers, beauty-parlor operators, and often meat cutters, and other tradesmen, huntsmen, fishermen; and other nontax records could be employed by collectors much more generously than has ever been done. In much the same fashion, utility regulatory agencies can provide data regarding the identity of numerous corporations and of their officers, which is a useful information medium for the tax collector. A few States, for instance, California and Idaho, have made special checks on such information sources. Where this has been done, such information should be available to Federal officials and would in all probability furnish an inexpensive and valuable lead in securing Federal income-tax compliance. As a means of securing income-tax compliance, Oregon checked personal property tax rolls for possible delinquents and followed up with field checks, by confidential personal interviews with local assessors and by personally interviewing the suspected evader. The harvest was inexpensive and abundant, and improved conditions invited future activity. The practice in certain States of correlating sales-tax audits with income-tax returns suggests another compliance possibility in sales tax States. With the current imposition of Federal taxes on smaller incomes, there should be some cooperative arrangement whereby accumulated State experience in administering the income tax on lower bracket incomes could be made available to the Bureau of Internal Revenue.

[72] Interview with George J. Schoeneman, Deputy Commissioner, Victor H. Self, Assistant Deputy Commissioner, and A. H. Cross, Executive Assistant, Accounts and Collections Unit, Bureau of Internal Revenue, June 1942.

[73] Thus an oil company might (and according to many State officials, some do) make a plausible case for giving special weight to the sales factor in the oil-producing State, to the producing and selling in the refining State, and to either producing or refining in the State of sale to the final consumer. Since most States allow administrators a remarkable amount of discretion in the allocation of interstate income, the company might be successful in all three States.

is the enactment of uniform allocation formulas and uniform definitions of allocation factors. By bringing the problem into clear focus and by obtaining the support of officials who are helpless to prevent either injustice or tax avoidance unless they have uniform formulas to administer, cooperation in administration may lead to substantive interstate coordination of taxes.

Other opportunities for interstate cooperation in income-tax administration may be cited. Every State receives information returns relating to residents of other States. At present, most of those returns are simply discarded. However, if other States would follow the lead of Mississippi and automatically transmit such returns to the proper States, the information-at-source dragnet would be considerably tighter. Such interchange might lead to liquidation of unnecessary differences in information returns to permit the forms of one State to fit into the administrative procedures of others. It might have other desirable results. Superior information-at-source practices of one State would be brought to the attention of others and might be adopted by the latter. Eventually, rather than have each State deal directly with all others, the States might set up a clearinghouse to which all out-of-State returns would be sent for redistribution. The Federal-State Fiscal Authority proposed in this study might well perform such clearinghouse services.

(4) *Informal Federal-State tax cooperation.*—Informal Federal-State cooperation already existing in tax administration varies almost as much as the complexion of problems confronted. And yet developments along this line are, with a few exceptions, quantitatively meager. In general, informal—and often extralegal—joint activity of the Bureau and State tax administrators has occurred in many directions; but in only a few cases has the extent of cooperative work been notable.

Many collectors of internal revenue have numerous kinds of agreeable and economical arrangements with State administrators. The list of Federal income-tax payers in a given State is provided State authorities; the State officers supply a list of automobile licenses to the collector of internal revenue. The collector gives an informal tip respecting the whereabouts of a delinquent taxpayer who has left the State; the State reciprocates—perhaps at an entirely different time—by giving information to the collector regarding another taxpayer's concealed property which renders possible collection of a Federal tax bill previously deemed uncollectible. One week a zone deputy collector drives his car over remote territory and invites a State field representative to ride; the next week the State investigator's automobile is used for both men. In some cases joint investigations are conducted by Federal and State field staffs. However, the extent of joint audits and appraisals seems to be almost negligible except in the case of death and gift tax appraisals where it is fairly common in some States.

Undoubtedly the most thoroughly developed case of informal cooperation exemplified in present Federal-State practice is found in the alcoholic beverage tax field. The present Federal alcoholic tax unit and its predecessors have followed a policy of full cooperation with State and local officials. The precise character of the cooperative arrangement has differed from State to State and even from city to city or from county to county within a State. The explanation of such differences lies in the complexion of the specific problems confronted and also to a large extent in the varying willingness of State officials to work with the Bureau.

Because the degree of State and local cooperation differs in various areas, the alcohol tax unit has adhered to the policy of leaving its field staff entirely free to work out whatever joint arrangements could be perfected in each individual community. There is, therefore, no standard procedure. The alcohol tax unit has prepared no written instructions with respect to how activities shall be carried on in conjunction with State and local officials. The fundamental fact is that the unit is always willing to cooperate and goes as far with cooperative procedure in each instance as seems fruitful in achieving the Government's purposes and in assisting the States.

The character of the cooperative effort differs as widely as the extent to which it is carried. In many cases, the detection of illicit distilled spirits manufacturing is handled jointly by Federal and State officers. On other occasions, even though State personnel develops an important case, prosecution is actually turned over to alcohol tax unit men, so that the case can be heard in Federal courts. In some other instances, certain types of cases which can be handled more expeditiously in the local courts are so handled, even though developed by the alcohol tax unit agents. In the direct tax administration procedure there is less complete cooperation, but joint effort is not lacking. Information is exchanged freely. In some cases, the State requires that the producers or vendors of alcoholic beverages have Federal stamps; or, if they do not have them, State officials may report to alcohol tax unit officers; and at the same time, Federal officers report irregularities under the State law to State officers. Although Federal alcohol tax unit men may not effect direct, informal transfer to State officials or agents of reports regarding liquor movements, the State field agents can ordinarily secure the information by appearing in the licensee's place of business with an alcohol tax unit representative and examining the licensee's copy of forms 52 (a) and 52 (b). In addition, Federal agents, unlike those in other branches of the internal revenue field service, testify freely in State courts respecting subject matter within their official assignments. By the same token, State representatives frequently are used as alcohol tax unit witnesses in proceedings instituted in the Federal courts.

Testimony from both State and Federal officials is unanimous to the effect that (a) the degree and diversity of cooperation in alcohol tax law enforcement is increasing gradually; (b) that the cooperative arrangement is substantially without elements of friction; and (c) that both classes of officials believe that the informal working procedure is mutually helpful, conducive to improved relationships between the different levels of government, and operates to reduce the total cost of regulating the alcohol-beverage business and of administering the taxes imposed upon it.

Many further opportunities for Federal-State administrative cooperation readily suggest themselves. Among them are joint programs for the training of personnel and of use of research and statistical resources. Of particular importance, both because of the strategic place of the income tax in a modern revenue system and because of the trend toward a broader base, are studies which will improve the techniques for applying the income tax to large numbers of persons not now covered and more effectively as to certain classes such as farmers, small businessmen and those in the professions. Attempts to utilize a single return for State and Federal income-tax reporting have thus far proved abortive, but the experience is by no means conclusive on the matter.

(*b*) *Joint or delegated administration.*

In the advanced stages of Federal-State collaboration in tax administration, cooperation will naturally tend more and more to take the form of joint or delegated administration. By the former is meant a more or less free exchange of personnel and other facilities by working agreements, formal or informal. By the latter is meant contractual arrangements for a complete transfer of administrative tasks from one governmental level to another

The experience of the Federal Government with the automobile use tax is particularly illuminating on the matter of administrative collaboration. Congress, in its 1941 Revenue Act, imposed a small annual use tax on automobiles, a move which in effect put the Federal Government in the field of motor-vehicle license taxation along with the States and some municipalities. At the time of its enactment, Congress seems to have given only slight attention to the question of how this tax could be administered. Considering the fact that there are some 30 million motor vehicles in the United States, the problem would seem to be extensive. Confronted with the question of how the Federal Government could collect this levy, the average man on the street or a member of Congress would reply: "Why not let the State officials collect this extra charge with their own motor-vehicle license fees?"

The Bureau of Internal Revenue considered three plans for administering the automobile use tax. The first contemplated a mail circulation of automobile owners to be followed by personal canvass of delinquents in the field. The mailing list was to be obtained from a private agency, which in turn got most of its information from the State licensing agencies. The second plan consisted of utilization of State facilities and personnel, as suggested above, and the third contemplated the use of post offices, publicity, and windshield stickers as a means of administration.

The first plan was favored by the Bureau as providing opportunity for the most thorough enforcement. It promised high administrative costs, however, and was rejected when special funds for the purpose appeared to be unavailable. The third plan, actually adopted, offered the advantage of the least administrative cost.

Principal interest here is in the second plan and the reason why it seemed impractical to the Bureau. The reasons were mainly as follows:

1. Authorization of a bargain with State officials on the part of either the Federal officials or those of the States was not clearly present. It has long been established that State officials have the general obligation to carry out Federal laws. But something more definite than this seemed to be required to obligate State officials and taxpayers, if State collection of Federal taxes were to be inaugurated.

2. The willingness of the States to undertake the administration of the automobile use tax was questionable. No formal conference with State officials was called, but some were sounded out individually and some dissent was observed. In some cases, political hostility to

the administration or to increased motor-vehicle taxes was thought to threaten the success of the plan.

3. The Federal authorities felt that they had no adequate power or influence to insure adequate enforcement or accounting by the States. Administration of State motor-vehicle taxes as in the case of other State taxes was thought to be spotty as to quality, very good in some States and bad in others. To the rather forbidding prospect of dealing with 48 different jurisdictions was added the complication that some States have decentralized their administration and rely on county officials for enforcement. Authority to bond State officials to insure proper handling of Federal money and authority to prescribe and enforce standards of accounting seemed to be lacking. There was no assurance that the States could be given a sufficient equity in the results of administration to insure adequate interest, or that the Federal Government could maintain standards by any threat of withdrawal of State privileges or of alternative direct Federal administration.

4. State laws varied widely as to time of collection, and it was thought that complications would develop therefrom in the enforcement of the Federal law by the States. Particularly the applications of the tax to newly purchased cars was thought to involve difficulty.

An incident of some interest in this story is the evidence of voluntary State cooperation in the enforcement of the Federal law. Some States require that the tax be paid before a State license is issued. In Michigan and Massachusetts, arrests have been made when cars were caught without stickers; and a bill was introduced in the Virginia Legislature to make it a misdemeanor to operate on the highways of the State without a Federal sticker.

The conclusion of the Bureau of Internal Revenue that, under these circumstances, the use of State tax machinery to enforce the Federal automobile use tax was impractical, and the above reasons for this conclusion, afford an opportunity for certain deductions as to Federal-State administrative cooperation in general:

1. Delegated administration cannot be improvised but requires very careful and detailed preparation.

2. The Federal Government must have some means of insuring the maintenance of standards.

3. A condition of Federal delegation is that the States, rather than the counties, carry the responsibility of administration at the State level; 48 States alone represent a quite sufficient dispersion of authority; where the Federal Government is obliged to deal directly with counties, the task of effective collaboration is very greatly enlarged.

At one time Federal officials and those of New York State attempted to work out a joint Federal-State income tax return. But no very serious effort was made and the negotiators appear to have been easily discouraged. Similar efforts in Canada proved successful in the case of four Provinces with results reported to be eminently satisfactory. Such joint returns require a substantially uniform definition of income, but permit variations in exemptions, deductions, and rates. State laws differ from Federal and from each other in a few important respects and in many insignificant details. But there is also a very large amount of common ground. Were a few States to achieve a working arrangement with joint returns, it seems reasonable to assume that others would follow, and also that a movement toward uniformity in definition would receive a very powerful impetus.

In the case of other taxes, the possibilities of joint administration are greatest for death taxes. Here the present crediting device might be so modified as to make duplicate administration largely unnecessary. The urge to move in this direction is strengthened by the observation that death-tax administration at the State level is, on the whole, ineffective. If the Federal Government should adopt a retail sales tax as a war measure, possibilities of collaboration in the administration of this tax would be very substantial and even joint or delegated administration might be worth consideration.

2. FEDERAL-STATE FISCAL AUTHORITY

A large gap in our machinery of government could be filled by the development of a Federal-State Fiscal Authority. This recommendation is in line with the approach taken here, namely, that the problems of intergovernmental relations are not likely to be settled all at once, but that constant study of and readjustment in intergovernmental arrangements will be necessary; also that the keynote in future intergovernmental arrangements should be cooperation rather than subordination.

A Federal-State Fiscal Authority could be expected to perform the following functions:

(1) Promote close collaboration among State and Federal administrators with the objective of joint administration of selected overlapping taxes. Administrators have made some progress toward coordinated tax administration, notably in making Federal income tax information available to the States. Also in the liquor tax field, collaboration of State and Federal officials is highly developed and has proved mutually satisfactory. However, efforts to devise and inaugurate a joint return for Federal and State income-tax reporting have proved abortive. Recent experiences with the Federal automobile use tax warrants the conclusion that effective Federal-State cooperation in administration cannot be improvised, but requires extensive negotiation and preparation. A Federal-State Fiscal Authority would be admirably suited for this role.

It seems very probable that the administrative approach to the problem of coordination might prove the most fruitful one to take in the case of net-income taxes, business taxes, and possibly death taxes, and sales taxes (if the Federal Government enters this field); joint returns, joint audits, and joint use of personnel, offer possibilities for future development.

Much could be said for an Authority which would administer overlapping taxes directly. The experience of Australia, which has made greatest progress in the administrative approach to the coordination problem, points toward a joint administrative agency. But Australia's problem is simpler than that of the United States. The Commonwealth has only 6 states and their revenue systems are more important relatively than those of our 48 States. (The latter factor creates a more even balance of power.) Eventually a Federal-State Fiscal Authority of the type here recommended would be given power to administer some taxes in its own right. But at the outset its role had best be confined to that of mediation between Federal and State officials. It should be observed, however, that joint administration is not Federal administration; a large factor of mutuality is implied.

(2) Promote interstate cooperation. The Authority, working with existing agencies, might facilitate interstate cooperation. For example, it might promote reciprocity legislation, as in the licensing of out-of-State trucks.

The Council of State Governments, among others, has perceived for some time that a much greater degree of interstate cooperation is required to maintain our Federal system in a healthy condition. Some of the gravest problems in the field of intergovernmental relations might be solved were there a sufficient degree of interstate cooperation. Of all the remedies for these many problems, interstate cooperation ranks first in its promotion of the prestige and independence of the States. But interstate cooperation to function most efficiently needs a "friend at court" within the Federal Government. And it needs an easy vehicle of transition from the field of interstate to that of Federal-State cooperation. A Federal-State agency should supply the factors needed to lift interstate cooperation to a much more active and more useful plane.

(3) Act as a clearing house for proposals relating to Federal payments in lieu of property taxes on federally owned property. In the past, legislation in this field has followed no consistent principles and an unduly complicated pattern of procedure has developed.

(4) Act as a board of appeals to hear complaints regarding Federal payments in lieu of taxes and the use of taxation or other instrumentalities as trade barriers.

(5) Conduct research. Evidence of high costs of excessive tax machinery both to governments and to taxpayers is sufficient to warrant much more intensive study than this subject has thus far received. It is extraordinary that almost no evidence is available concerning the compliance costs of our social security system with its substantial reporting requirements. Similarly, only scattered and inconclusive evidence is available concerning the effects on interstate business firms of diverse apportionment formulas applied under income and business taxes. Little convincing evidence is available concerning the importance of taxation as a business cost, and of differential tax burdens as a factor in industrial location and relocation. These fields could be cultivated to excellent advantage, either directly by, or through the stimulation of a Federal-State tax authority.

(6) Create public interest in intergovernmental relations. Public apathy does not signify that the problem is unimportant. That the public (excepting certain classes of taxpayers seriously inconvenienced by duplication) has never been much interested in the frictional expense involved in taxation is evident enough from the paucity of data concerning these costs. Public concern in these matters, however, can and should be developed.

(7) Disseminate among the States information on Federal taxes and economic trends as they affect the States.

(8) Promote better governmental reporting, accounting, and statistics.

The question will be raised: If we are to have a Federal-State authority, should it not be given a mandate to cover much more than fiscal matters? It might be desirable eventually to extend the mandate to cover the larger field of Federal-State relations. However, it seems that a more limited mandate, including taxes, budgets, and trade barriers, would be preferable in the first phase of this experiment, at least.

As to organization, it is suggested that the personnel of the Authority should consist of one member appointed by the President, one selected by a conference of delegates named by State Governors, and one named by these two, all to be suitably qualified in the field of intergovernmental fiscal relations. There is much to be said in favor of specific representation for municipalities. While it may be desirable to broaden the commission eventually, it is believed that at the outset its size should be kept at a minimum. The legislation creating the Authority might well specify that one of the appointees should have some specific knowledge of municipal affairs. An advisory council, suggested below, should serve to broaden the representation. Terms might be staggered, and of 4 years' duration; the office should be located in Washington.

Intergovernmental cooperation is not likely to develop very far except through the process of a meeting of a large number of minds. Representation and conference are the essence of this procedure, and either by legislation or working rule, a Federal-State-agency program should include an advisory council. The council would provide a means of getting a consensus. It should afford direct representation of congressional committees and recognized organizations of State and local and Federal officials.

It is proposed that $150,000 to $200,000 be authorized as the initial budget of the Authority, and that half of this fund be appropriated by the Federal Government without any contingent (matching) provision, the other half to be raised from State legislatures through the body which designates the State appointee. The State contribution is essential to maintain a balance of the interests represented on the authority. It is recognized that the process of raising financial support in the States will involve delay and uncertainty. The Federal share should be sufficient to enable the Authority to make a showing.

The plan of organization here proposed contemplates that as soon as the authority has been authorized by Congress and the Federal appointee has been named by the President, the latter should call upon the States to designate their appointee. The selection might be made through a conference of delegates named by the Governors. A plan for financing the State share of the Authority's cost would also be adopted by this conference. A fair method of distributing the States' share would be in proportion to the amounts of State and local taxes raised. This outline of procedure is suggestive only. One alternative method would be to provide for selection of the States' representative by the Governors, the choice of a method of selection being left to the Governors.

The impression should not be conveyed that the development of administrative collaboration is impossible without a Federal-State agency. Much cooperation could be achieved without any new administrative body. New interest and a new cooperative attitude would be sufficient, but the Federal-State agency should help develop this new outlook, and the latter might not be forthcoming without some new factor of the sort suggested.

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3. SEPARATION OF SOURCES

(*a*) *Historical place.*

Of all the proposed devices for achieving coordination of overlapping taxes and expenditures, that known as separation of sources is the one which has the longest history of successful application.

As previously stated, the Federal Government from its inception well into the twentieth century confined itself largely, except during emergencies, to customs and excises, sources which the States either by restriction or choice did not utilize. In recent years, however, the revenue system has been broadened at both the State and Federal levels. As previously stated, overlapping taxes have developed in numerous tax fields. Although talk of a division of territory to prevent the overlapping has continued, the discussion seems quite academic, particularly in view of the recent Federal move, in spite of protest, into the already well-developed motor-vehicle-tax field.

(*b*) *Kinds of separation of sources.*

The achievement of separation of sources may be either by constitutional restriction or forbearance. For example, it would be possible so to amend the Constitution as to give the Federal Government or the States a monopoly of the income tax or the inheritance tax or both. Such amendment has no sufficient possibility of enactment to make it more than of academic interest. Perhaps in view of recent events, it should be concluded that forbearance is also an academic subject. But one is loath to accept this view, and it seems possible that a plan of division supported by an agency with such prestige as a Federal-State Fiscal Authority could command, might still achieve some results in separation.

The fathers were not unaware of the dangers of overlapping taxes and were of the opinion that forbearance would prevent the combination of revenue sources from becoming onerous. At least this view was expressed by The Federalist as follows:

> It is, indeed, possible that a tax might be laid on a particular article by a State which might render it inexpedient that thus a further tax should be laid on the same article by the Union; but it would not imply a constitutional inability to impose a further tax. The quality of the imposition, the expediency or inexpediency of the increase on either side, would be mutually questions of prudence; but there would be involved no direct contradiction of power. The particular policy of the national and of the State systems of finance might now and then not exactly coincide, and might require reciprocal forbearance.[74]

Separation of two sorts has been recommended: the first calls for a division of tax sources themselves, and the second calls for a division of territory within a given tax field. The first is the traditional proposal of separation; the second is exemplified by the suggested division of the income- and inheritance-tax fields, the Federal Government to tax the high brackets in these fields and the States the lower brackets. A suggestion of this kind was recently made by William J. Shultz [75] who proposed a "reciprocity clause" in the Federal income tax providing an exemption for all incomes under $10,000 reported from States in which the tax laws exempt incomes over $10,000. This is equivalent in many respects to a tax credit of 100 percent for State income taxes in low brackets. It ignores, however, the degree

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[74] The Federalist, No. XXXII.

[75] William J. Shultz, "Coordinating Federal and State Taxation," Essential Facts for Fiscal Policy, National Industrial Conference Board, 1941, pp. 120-130.

to which the States cultivate their income-tax fields. The credit appears to be a more flexible device for accomplishing the same objective.

(*c*) *Basis of separation; possible application.*

If a separation of sources is deemed still within the realm of feasibility, the question arises as to the principles upon which the sources should be allotted. Obviously, relative ease of good administration at the different levels should be weighed heavily and other factors of suitability, such as propensities to migrate from the tax and multiple taxation complications, need to be taken into account. The need for State and local revenue, independently levied, must be carefully considered. Of the overlapping taxes, the gasoline tax and motor-vehicle-license tax seem relatively good prospects for exclusive State revenue, and the tobacco tax for exclusive Federal use. The former can be quite well administered by the States, while the latter is both costly (as compared with the Federal administration) and otherwise limited in administration at the State level. The stock transfer tax is another instance where the Federal Government has the stronger claim. Its present use by New York results in an extraterritorial incidence, and its wide use by other States would involve perplexing problems of multiple taxation.

Brazil alone of the principal federal governments has attempted complete separation of Federal and State revenue sources. Grants to the States are small, and the 1937 constitution clearly divides the different tax sources between the Federal and the State Governments. No information has been obtained concerning the operation of this new system.

4. DEDUCTIBILITY

A coordination device seldom recognized as such is the deductibility of taxes levied by other jurisdictions in calculating the net base of the tax in the taxing jurisdiction. In the United States, this is most highly developed in the field of Federal and State income taxes. The mechanics and effects of deductibility will be considered in some detail later. Here it may be observed that deductibility for State income taxes in calculating Federal taxes, and, to a lesser extent, the reverse, affects coordination in that it very materially reduces the total load of the two taxes, diminishes the differentials between income-tax burdens in an income-tax State and those in a non-income-tax State, and avoids threats of confiscation. The deductibility features are, in effect, a mild form of credit. They play a useful function as a curb to tax avoidance by migration—a role which has received almost no recognition at all. In the death-tax field, where the crediting device plays a prominent part, deductibility is of small importance. Nevertheless, over half the States allow deductibility for Federal estate taxes and some, in addition, allow a deduction for taxes paid to other States.

5. CREDITING

(*a*) *Development and present place of crediting in our revenue system.*

The development of the Federal estate-tax credit has already been described in the historical section of the introduction to this report. The prolonged struggle between the States and the Federal Government over the death tax during the twenties ended in a compromise settlement still in effect. It provides that within limits the taxpayer may pay his Federal estate tax with State death-tax receipts. The limit is 80 percent of the Federal tax computed according to the 1926 schedule of rates and exemptions. One effect of the credit is to deprive a State which has no death tax of any revenue from this source, although its residents may have to pay quite as much tax as though they lived in a State which imposed such a tax.

Florida, which had not previously employed the death tax, carried the Federal credit law to the United States Supreme Court, contending that it was unconstitutional because it was not uniform in its effect and was an undue interference by the Federal Government with the freedom of the States in their choice of a revenue system. The Supreme Court, however, in a unanimous decision, sustained the law.[78] By a substantial majority Florida voted, in 1930, to amend its constitution, repealing the prohibition of death taxes in that State. The amendment permitted an estate tax but only for as long as the Federal credit might be in force, and only to the extent necessary to absorb the full credit allowed against the Federal tax. Many other States have also enacted minimum estate-tax laws in addition to their regular inheritance tax. The minimum estate tax insures them the full benefit of the Federal credit.

As a part of the social-security program an excise tax was levied upon the pay roll of employers of eight or more persons. This was to support an unemployment-compensation system, which the law contemplated would be set up and administered by the States. The Federal Government levies a tax but allows a 90-percent credit on taxes paid by employers under approved State unemployment-compensation plans. Under this arrangement, State pay-roll taxes and unemployment-compensation systems have become universal.

(*b*) *Advantages and limitations of crediting.*

The crediting device has been frequently recommended for extension and particularly as a solution for uncoordinated, overlapping taxation in the income-tax field. It is fairly obvious that a credit can be used to stimulate universal acceptance and application of a tax and to defeat the propensities of some States to bid against others for the location of wealthy individuals and prosperous industries by means of "easy" tax laws. Federal credits may involve a sacrifice of revenue by the Federal Government, a very serious consideration in view of present and contemplated shortages in the Federal Budget. Additional limitations to the credit as thus far employed have been enumerated as follows: It does nothing about costs and irritations of dual administration, gives no relief for multiple taxation resulting from conflicting State jurisdiction, and exerts only a mild influence in the direction of uniformity. The last of these alleged limitations might be disputed, but the remaining high degree of diversity in the death-tax field can be cited to support the allegation.

For the income-tax field, credit has many objections in addition to the general ones already mentioned. The State income tax is applied by only about two-thirds of the States and the remaining ones object to what they interpret as coercion. There has always been a considerable number of tax students who have doubted the wisdom of State income taxation superimposed upon Federal, and who would

[78] *Florida* v. *Mellon* (273 U. S. 12 (1927)).

consider the credit as encouragement of the States to plough further and deeper into the income-tax field. Finally, the details of a Federal credit, particularly the definition of State corporate income taxation which would be acceptable for crediting, are troublesome. These matters are discussed in greater detail later.

(c) *Possible modifications in and further application of the credit.*

Although the limitations to the crediting device, stated above, seem to be supported by experience, nevertheless, it should be observed that the device has only been used in one way and under one set of circumstances. It would be possible to modify the credit in the direction of the shared-tax type of coordination instrument. This could be done by encouraging the States to accept the credit in lieu of an independent tax, this on condition that the Federal Government determine the jurisdiction problems of allocating State tax bases, and offer the States the service of administration and collection or a joint arrangement in the performance of these functions. This makes of the credit almost a shared tax and leaves the former with some of the objections raised against the latter. However, a modified credit of this character might be quite advantageous in particular circumstances and it is recommended with qualifications for the death-tax field. (See pp. 478 ff.).

The flexibility of the credit instrument extends also to the use of graduation. It is possible to give a higher percentage credit on low brackets than on high brackets. The logic of such an arrangement would be that large incomes and inheritances are more appropriate subjects for Federal taxation than the small ones, and vice versa for the States. The individuals and businesses who occupy the high brackets are the most migratory and most likely to draw their resources from wide areas and absentee sources. The graduated credit has much to commend it and deserves careful consideration.[77]

6. SHARING

(a) *Introduction: Nature of sharing.*

Perhaps the most common of all proposals for Federal-State tax coordination is that the Federal Government under modern conditions should assess and collect the taxes and divide the yield to take care of the fiscal needs of the States and their subdivisions. Though the Federal Government has made little if any use of this device, there is time-honored precedent for sharing in the experience of the States. Some of the States from their beginning have made a practice of distributing a portion of their revenues to cities, towns, and other local units. Sharing involves more centralization than any other coordination device except reallocation of functions. It involves centralization both as to the levy of taxes and as to their administration, leaving local discretion only as to expenditure. Local supplementation of Federal taxes leaves local discretion as to levy. Federal grants assume central discretion as to levies, administration, and expenditures, but they are presumably confined to functions in which there is a national interest.

[77] The use of credits by the States as an antidote for multiple taxation is a species of coordination device, not to be confused with the Federal credit. The State credits are discussed in this report on p. 241.

(*b*) *Advantages of sharing.*

Federal sharing would make dual administration unnecessary, and might result in a completely coordinated tax system. It is a way by which the superior position and obvious advantages in central tax collection can be exploited without destroying local independence as to expenditures.

(*c*) *Objections to sharing.*

The system of central collection and local sharing is very attractive to those who attach a great importance to logical and simple mechanisms. But there are very impressive objections to the shared-tax institution. Presumably, it contemplates distribution to the States from which taxes originated. Over half (57 percent) of what have been classified as State-collected locally shared taxes was in 1935 distributed to the local units in this way.[78] This aim is to leave the units receiving the revenue with a proprietary interest in the latter and its expenditure. Under these circumstances, the central units can be regarded as merely aiding the local ones "to tap their own resources."

Distribution of tax revenues by States according to origin has encountered two major difficulties. In the case of the income tax, which is perhaps one of the easier ones to allocate, there is the problem arising from the relative claims of the district of the recipient's domicile and the district where the income originates. There is also the plausible claim that the whole area in which exchange is carried on creates the income of one engaged directly or indirectly in such exchange. Distribution at the Federal level would involve Federal arbitration of the jurisdictional conflicts of the States, including not only the domicile-versus-situs issue but also allocation formulas as applied to business income.

Accurate determination of origin in the case of tobacco, liquor, gasoline, and other excise taxes also involves considerable difficulty. Most of the advantages of central administration and collection disappear if facts on sales and consumption (quite decentralized) have to be gathered in order to carry out a distribution.

The second and more important difficulty in distribution according to origin is that it frequently bestows upon some fortunate districts far more revenue than such districts have need of or can utilize to the best advantage. Examples abound of wealthy suburbs, tax colonies, and small districts with a big and successful factory or public utility, which get from the State in shared taxes what appears to be an inordinate proportion of State-collected taxes. At the national level, the problem is less acute but otherwise the same. The less affluent States would undoubtedly resent distribution of federally collected income and inheritance taxes according to origin, and thus heavily weighted in favor of New York State.

To be sure, it is possible to abandon origin as a criterion for distributing shared taxes and to inaugurate some other basis, either arbitrary in character or based on need. But the arbitrary standard would usually be none too defensible or stable, and the needs basis makes the shared tax not very different from an aid. The aid instrumentality would ordinarily leave the receiving units less discretion

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[78] Mabel Newcomer, "Revenue Sharing Between Federal and State Governments and Between State and Local Governments," Proceedings of the National Tax Association, 1936, p. 280.

in spending; it is a means of securing expenditures on functions in which there is a central interest. Origin is an objective criterion and, once it is abandoned, all the hazards of territorial rivalry in congressional politics enter.

Those who object to State taxation of incomes and inheritances would achieve only part of their purpose through application of the shared-tax device. For example, both these sources, when applied at the State level, provide revenues that fluctuate widely from year to year. Shared taxes distributed according to origin would not avoid this limitation.

There are those who conceive a shared-tax program as in no sense an infraction of the fiscal independence of the receiving units. Presumably, the shared taxes would be distributed upon the condition that the States abandon the independent taxation of the sources from which taxes are distributed. Presumably, further, the States could not afford, in most cases, to maintain their own independent taxes in opposition to the Federal condition. This would mean that rates, exemptions, and revenues for the shared taxes would be a matter of Federal determination. It would mean that the basis of distribution itself could be changed at the will of Congress. To be sure, the receiving units would have discretion in spending such revenues as Congress thought fit to give them. They would retain about as much fiscal independence as a minor son placed on a revocable allowance by a generous father. It might be well to recall how much power the Federal Government had (under the Articles of Confederation) when it relied largely on the discretion of the States for revenue.

In one sense, the States are in a stronger position with regard to shared taxes distributed by the Federal Government than are the municipalities with regard to shared taxes distributed by the States. The municipalities do not have the independent taxing power that the States possess. The latter cannot be forced out of the taxing fields they now occupy (without a constitutional amendment); they have to be offered financial inducement. As a political matter this would probably require payments at least equivalent to what the States are now getting in revenue from each source. Theoretically, something less than this might be required; a sharing plan which offered the States Federal revenue on condition that the former modify their tax systems would be effective even if the amounts offered were less than the present State receipts. It is always difficult to reject a proposition which involves any sharing in generally collected revenues. As a practical matter, however, any program seeking to purchase a surrender of State taxing powers would have to be very liberal to insure a degree of State acceptance which in turn would insure favorable action in Congress.

Recently the New York State Commission on State Aid to Municipal Subdivisions recommended "that the sharing of all State-collected and locally shared taxes, with the exception of motor-vehicle license and motor-fuel taxes, be abandoned."[79] This conclusion was based on the ground that these taxes fluctuate so greatly in revenue that they are not dependable sources of income, and that their use is not readily controlled. These criticisms have equal validity as applied to Federal sharing.

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[79] Report of the New York State Commission on State Aid to Municipal Subdivisions, Legislative Doc. No. 58, 1936, p. 10.

As previously stated, the Federal Government had a "golden opportunity" to apply the shared-tax principle and to assume a monopoly of liquor taxes in 1934, when a new tax was being inaugurated and no vested interests had to be encountered. For some of the reasons stated above, the opportunity was missed. In practice, the program of federally collected and State-shared taxes encounters great, if not insuperable, political obstacles.

(*d*) *Foreign experience with sharing.*

Germany, in 1919, and Argentina, in 1934, adopted comprehensive systems of shared Federal taxes, supplemented by relatively small grants. These have solved the problem of overlapping taxes (although Argentina permits both Federal and provincial inheritance taxes) but they are neither readily adjusted to State needs nor do they foster responsibility. The Argentine system is not completely in effect, the provinces having failed to give up some of the overlapping taxes, and the German experience with this system was not a happy one; it was greatly modified during the 20 years from the First World War to the Second. The shared taxes led to State and local extravagance in the few years of prosperity in which they were being distributed, and in time of depression they brought maldistribution of funds, since the neediest districts in general received the least. Constant revision was found necessary in order to keep the system functioning at all.

In Argentina the sharing system includes the sales tax, income tax, land taxes, industrial and professional taxes and internal excises.

(*e*) *Situation where sharing would be most advantageous; possible Federal application.*

The tax situation most favorable for sharing would present the following characteristics:

1. State imposition of the tax must be fairly general and fairly uniform. Otherwise, the charge will be made that the Federal Government is forcing the spread of a particular kind of tax. Some degree of uniformity is necessary, also, in order to strike a least common denominator of distribution which will satisfy most of the States and at the same time not be wasteful of Federal money.

2. State administration must be expensive or otherwise unsatisfactory. This provides the cause for action in inaugurating sharing.

3. Simple and acceptable bases of distribution must be readily available. This will help to avoid excessive politics.

4. States must have a relatively small stake in their discretion over rates and other provisions connected with the particular tax. This is important to minimize the loss of State sovereignty which sharing involves.

If any Federal-State tax situation presents all these characteristics, it might be worth recommending for an application of the sharing device, at least as an experiment. The tobacco tax is the principal candidate and it measures up to the above qualifications fairly well.

7. STATE SUPPLEMENTS TO FEDERAL TAXES

The possibilities and advantages of various forms and degrees of joint Federal-State administration have been considered. A proposal of somewhat the same character is that the Federal Government impose and administer certain taxes, at the same time inviting the States to add a percentage to the Federal levies. Such a procedure has been a common practice in France.[80] In the Mexican federal system, both the State and Federal governments have levied both direct and indirect taxes. Duplication has not taken the form of independent levies, however, so much as additions to one another's taxes. The Federal levy on the States has sometimes taken the form of a percentage of all State tax collections, regardless of source, and sometimes an addition to the property tax. Local governments have been permitted to make limited additions to specific Federal taxes.[81] There is some precedent for supplementation in the United States, and it is recommended by high authority.[82] One or two States tried adding a percentage to the Federal income tax, but abandoned the plan. Several States now use the Federal corporation income-tax base for their own levies. The American States have too much independence to relish the prospect of Congress amending their tax laws. Nevertheless, gradual efforts to effect a greater degree of uniformity in income-tax laws and to merge Federal and State administration still represent one of the most promising approaches to the coördination problem. Supplementation (consisting mainly of delegated or joint administration plus uniformity) is a matter of degree and a very desirable goal to work toward, especially in the income-tax, business-tax, and retail-sales-tax fields (if the Federal Government adopts a retail-sales tax). Definite implementation of supplements might be provided by Congress in the form of legislation which would offer the States administrative services in case their tax laws were based completely on the Federal law. But it seems better to work toward uniformity and joint administration of all the overlapping income taxes, making progress in this direction by degrees.

8. GRANTS-IN-AID

(a) *Definition.*

The term "grants" and the term "shared taxes" are often loosely and sometimes synonymously used. The criterion of differentiation most commonly applied is that the grant-in-aid is distributed by appropriation, whereas the shared tax is apportioned according to fixed percentages of the yield of a particular tax; in case of an aid, the amount distributed is largely independent of the yield of a particular tax; in the case of a shared tax, it is entirely dependent upon such yield. An appropriation from the State treasury for local education is a familiar example of aid; distribution to municipalities of a specified proportion of State income-tax receipts is a common form of State sharing of taxes.

(b) *Objectives.*

The objectives of grants-in-aid were excellently summarized many years ago by Sidney Webb in England as follows:[83]

(1) To effect an equitable mitigation of inequalities of burden among the units of government.

(2) To secure effective authority for necessary supervision and control by national government.

[80] E. R. A. Seligman, Essays in Taxation, tenth edition, New York, 1931, p. 664.
[81] W. F. McCaleb, The Public Finances of Mexico, New York, 1921, pp. 91, 103, 116–117.
[82] E. R. A. Seligman, "The Fiscal Outlook and the Coordination of Public Revenues," Current Problems in Public Finance, New York University Symposium, 1933, pp. 261–275.
[83] Sidney Webb, Grants-in-Aid: A Criticism and a Proposal, revised edition, 1920, pp. 9–26.

(3) To encourage the kind of expenditure most desirable in the interest of the community as a whole.

(4) To make possible a universal "national minimum" in certain public services.

The first of these objectives includes both general tax relief and equalization among districts. It covers the interests in a national distribution of income and death taxes, the base of which is thought to be of largely national origin. The "national minimum" referred to in the fourth is an elastic term covering minimum standards, as in educational, health, and welfare services. In the light of recent experience, perhaps a fifth objective should be added. This is the fiscal objective, the attempt to improve the over-all tax system and use public expenditure effectively to approach full employment.

(c) *Experience with Federal aid in the United States and other federal systems.*

It is not necessary here to relate the detailed history of Federal aids and the provisions of the laws granting aids for many purposes. Federal aids, in one form or another, are a very old institution beginning with the Ordinance of 1785 and first applied to the disposition of the public domain, especially in the promotion of education. Although in a few instances grants of money had previously been distributed among the States during periods of surplus revenues, it was not until 1887 that the present Federal system of annual money grants-in-aid was inaugurated. These aids have been gradually extended to include a variety of purposes, although it was only with the coming of the depression of the 'thirties and the widespread distress and unemployment of that period that they became of first-rate fiscal importance.

No provision was made in the original financial arrangements between Federal and State Governments in the United States for Federal aid to States. In fact, the development of any important grants to State or local governments is of recent origin, and arose from the Federal Government's interest in stimulating specific State services rather than from the necessity of giving financial assistance to enable the States to provide a minimum of essential services. There seems to have been no question of the adequacy of State revenue sources when the Federal Government was founded, and early financial difficulties arose from too rapid expansion of railroads, canals, and highways, rather than from inability to support ordinary government functions. Tax rates were rarely high. Since the earlier grants were for the purpose of encouraging new or better services, they were conditional grants, which ordinarily required matching from State funds.

The earlier developments of Federal aid in the Latin-American countries follow this pattern. No assistance was given in the early years, and when aid was provided it was usually in the form of conditional grants. Argentina has from time to time made special grants to meet State deficits, but there has been no regularity in such aid.

Developments in the European federations and the Dominions have been quite different. Switzerland provided, in the original financial arrangements, for a compensatory grant to the Cantons to cover losses from revenues given to the Federal Government. This was to equal the average income from these sources in the years immediately preceding federation, with the guaranty of a fixed sum per capita from the customs duties and excises, if this should prove larger than the average income for the specified years. Thus the Cantons could not lose from the bargain except as the revenues transferred increased in the years that followed. The reverse of this was, of course, that the Confederation could obtain its income only from increases in these revenues. Grants for specific Canton services were permissible, and were introduced very early. They were relatively small in amount in the first years of federation, but they grew rapidly. The compensatory grant was abandoned in 1874.

The grants have gone far toward raising the standard of Canton service. The Cantons have clearly lost a substantial measure of their independence, however, and the conclusion seems plausible that the expectation, when the federation was established, that the Cantons "would normally be and remain the tutors and benefactors of the Confederation," has not been realized. Instead they "have today become public charges on the Federal income." [84]

Germany's original bargain with the States was more favorable to the Federal Government than that of Switzerland. Instead of compensating the States for revenues taken over, the Federal Government reserved the right to levy on the States for additional revenues as it found need for them, and also received flat payments from the southern States for permitting them to retain their beer taxes and post offices. Only in 1879 did the Federal Government offer cash compensation to the States as an inducement to permit the Reich to increase customs duties. This resulted in substantial cash distributions to the states for a few years, but since the Reich retained its right to requisition the States for additional revenues, the distribution of "surplus" customs duties was soon more than counterbalanced by Federal requisitions. It was not until after the First World War that the States received any substantial assistance from the Reich.

The British Dominions followed the pattern of the Swiss financial arrangements in providing cash subsidies to the States in compensation for revenues taken over by the Federal Government. In addition, special grants were provided, in all the British federations, for the States and Provinces that appeared to suffer most from the change. Most of these were regarded as transition measures. In none was any provision made originally for grants for specific functions. But in all, as in the United States, Switzerland, Germany, and the Latin-American federations, such grants have been introduced in recent years; and in Canada they became much larger than the subsidies that were not earmarked for specific purposes.

Switzerland returned approximately one-third of her revenues to the Cantons in early years. Australia returned more than half, and Canada and the Union of South Africa returned less than one-fourth. Shared taxes were not found in any of the original agreements.

At the State-local level the grant for special functions, usually on a percentage basis, was developed early in most of these countries. In fact there is less variation in State aid, from one country to another, than in Federal aid, although the variation among States within each country has often been very wide.

(*d*) *Purposes of Federal aid.*

Grants by Congress rest upon its power to spend for the general welfare, but the aids involve indirect control in fields where Congress

[84] W. E. Rappard, The Government of Switzerland, Van Nostrand, New York, 1939, pp. 118-119.

has no power to control directly. Although a mild threat to the constitutional status of aids was apparent in one Supreme Court decision in the early years of the New Deal,[85] the later decisions upholding the Social Security Act seem to have removed any doubt about the validity of the Federal-aid program.[86]

Table 4 (pp. 163–65) presents a functional distribution of the Federal aids distributed in the fiscal year 1940–41. Some of the major aids may be briefly described as follows:

1. Agricultural colleges, experiment stations, and agricultural extension work: This includes Federal participation in the extensive program of activities centering about the county agents entrusted with carrying on extension work in agriculture and home economics.

2. Forest conservation work.

3. Highways: Since 1916, Federal aid for highway construction by the States has been provided in generous proportions. In 1930, about 75 percent of the Federal grants-in-aid was for highways.[87] In general, the aid is distributed according to the average of three ratios: area, population, and miles of post roads. Since 1921, the Federal law has required that the aid be used upon a Federal system of primary and connecting highways selected by the State highway departments with the approval of the United States Bureau of Public Roads, and that it be spent only for construction.[88] In general, Federal grants for State highway projects require matching on the part of the State, although during the depression years of the 'thirties this requirement was largely eliminated.

4. Vocational education: Under the Smith-Hughes Act of 1917, and regularly since, revenue has been appropriated to help pay the cost of teaching certain vocational subjects in secondary and vocational schools, and of training teachers of such subjects. The vocational subjects included at the present time are agriculture, home economics, industrial trades, and "distributive occupational subjects."

5. Vocational rehabilitation: This aid is to encourage the training, retraining, and placement of disabled people. Grants for this purpose were enlarged and made more secure by the Social Security Act.

6. Unemployment relief: Aids for this purpose were of major importance during the fiscal years 1933 to 1936. The program of that period was characterized as "the largest undertaking ever attempted through the grant."[89] During the 3 years from 1933 to 1936, Federal grants to the States for State administered direct and work-relief programs totaled more than $3,000,000,000. These aids not only assumed unprecedented proportions, they also created a new precedent in the discretion over their distribution that was given to the Federal relief administrator. Ordinarily, under Federal-aid programs, administrators are given scant, if any, discretion in the distribution of aids. They merely calculate the division according to the objective rule provided by the legislative body. Partly because of the emergency character of depression needs, and partly because of the urgent necessity of making the funds go as far as possible, this rule was abandoned in the Federal relief program. The administrator was, in effect, told to make his own determination of need and distribute

[85] *U. S.* v. *Butler* (297 U. S. 1 (1936)).

[86] *Stewart Machine Co.* v. *Davis* (301 U. S. 548 (1937)), *Helvering* v. *Davis* (301 U. S. 619 (1937)).

[87] Henry J. Bitterman, State and Federal Grants-in-Aid, Mintzer, Chicago, 1938, pp. 132-133.

[88] Recently there have been appropriations of special funds for purposes other than construction of main highways, such as the elimination of grade crossings and the construction of local farm-to-market roads.

[89] V. O. Key, Jr., The Administration of Federal Grants to States, Public Administration Service, Chicago, 1937, p. 17.

funds accordingly. He was given wide powers over the expenditure of the money, and in some cases took over the central administration of State relief and ran it from his own office.

By the end of the fiscal year 1936, strict grants-in-aid to the States for work relief were practically discontinued. In their place the Works Progress Administration, inaugurated in 1935, provided that most future projects were to be directly administered by the Federal Government, although in close collaboration with the States and municipalities. At the same time, the financing of direct relief for "unemployables" was left to the States.

7. Public unemployment service: This was a matching grant distributed on the basis of total population. Inaugurated in 1933, it has been discontinued during the war, when the Federal Government assumed direct responsibility for administering the public employment offices.

8. Public health and welfare service: This aid has been given intermittently since 1921 for public health work in the field of hygiene of maternity and infancy. The Social Security Act renewed Federal aid for this purpose and added further features for the care of dependent and disabled children and for more general public-health work.

9. Categorical public assistance: The Social Security Act also provided for grants-in-aid for three types of public assistance; the care of the aged, dependent children, and the blind. These were all grants of the matching, "open end" type providing, for the old-age assistance grant, that the Federal Government would match State and local outlays not to exceed a total of \$30 (now \$40) per month per individual receiving assistance. An additional 5 percent of outlays was granted to be used for the administrative costs of the program. The Federal law lays down fairly definite conditions for State programs in order to qualify for Federal aid.

10. Administration of unemployment compensation: The Social Security Act also provides funds to the States for meeting the administrative costs of State unemployment compensation systems, conditioned upon the approval of the State law by the Social Security Board and upon requirements concerning administrative procedure. The aid is unique in the that Federal Government meets the entire cost of the supported service.

TABLE 4.—*Regular Federal grants-in-aid to States as of June 30, 1941* [1]

Administrative authority and purpose of grant	Year established	Appropriation for fiscal year 1941	Basis of apportionment: Uniform lump sum per State	Basis of apportionment: Other bases	Basis of apportionment: Matching required of State (percent of grant)
DEPARTMENT OF AGRICULTURE		*Thousands*	*Thousands*		
Agricultural experiment stations	1887	\$1,440	\$30		
Do	1925	2,880	60		
Agricultural research	1935	2,400		Rural population	100

[1] Regular Federal grants-in-aid include periodic Federal payments to State (Territorial) and local governments for specified purposes. Three general categories of expenditures are excluded: (1) Grants financed from recovery and relief appropriations such as Public Works Administration grants and those for road and highway projects; (2) payments to individuals from regular and emergency appropriations such as the agricultural conservation program, Work Projects Administration, and Civilian Conservation Corps expenditures; and (3) direct Federal expenditures in cooperation with States such as those for the National Guard, the control of animal diseases, agricultural pest control, and farm forestry extension work.

TABLE 4.—*Regular Federal grants-in-aid to States as of June 30, 1941*—Continued

Administrative authority and purpose of grant	Year established	Appropriation for fiscal year 1941	Basis of apportionment		
			Uniform lump sum per State	Other bases	Matching required of State (percent of grant)
DEPARTMENT OF AGRICULTURE—continued		*Thousands*	*Thousands*		
Agricultural extension work	1914	$1,580	$10	Rural population	100
Do	1928	1,480	20	do	100
Do	1935	12,000	20	Farm population	
Do	1939	203		Such amounts as the Secretary of Agriculture may deem necessary.	
Distributions of forest planting stock	1924	100		Secretary of Agriculture may prescribe.	100
Forest fire cooperation	1911	2,200		do	100
DEPARTMENT OF THE INTERIOR					
Wildlife restoration	1937	2,500		One-half on area; one-half on number of paid hunting license holders.	
DEPARTMENT OF LABOR					
Maternal and child health	1935	5,820	20	{Live births / Financial need	100 / 100
Crippled children	1935	3,870	20	Number of needy crippled children and cost of service. Financial need.	100
Child welfare	1935	1,510	10	Remainder on basis of rural population.	
FEDERAL SECURITY AGENCY					
Colleges for agriculture and mechanic arts	1890	2,550	50		
Do	1935	2,480	20	Population	
Vocational education:					
(a) In agriculture	1917			Rural population	100
(b) In trades and industries	1917	7,000		Urban population	100
(c) Of teachers	1917			Population	100
Further development of vocational education:					
(a) In agriculture	1936			Farm population	50
(b) In home economics	1936			Rural population	50
(c) In trades and industries	1936	13,150		Nonfarm population	50
(d) In distributive occupations	1936			Population	50
(e) Of teachers	1936			do	100
Vocational rehabilitation	1920	2,319		$15,000 to Hawaii; remainder to States and Puerto Rico on basis of population.	100
Education of the blind	1879	125		Processsed material distributed on basis of number of pupils in public institutions for the blind.	
Public health work	1935	11,000		Population; special health problems and financial needs.	
Investigation and control of venereal diseases.	1918	5,672		Population; extent of venereal disease problem; financial need.	100
Old-age assistance	1935	245,000		50 percent of payments to needy aged (Federal share not to exceed $20 monthly per beneficiary) plus 5 percent of such amount for administrative purposes.	100

TABLE 4.—*Regular Federal grants-in-aid to States as of June 30, 1941*—Continued

Administrative authority and purpose of grant	Year established	Appropriation for fiscal year 1941	Basis of apportionment		
			Uniform lump sum per State	Other bases	Matching required of State (percent of grant)
FEDERAL SECURITY AGENCY—continued		*Thousands*	*Thousands*		
Aid to dependent children	1935	$75,000		50 percent of expenditures under approved State plan (excluding amounts paid to beneficiaries in excess of $18 for 1 child and $12 for each additional child in the same house per month).	100
Aid to the blind	1935	10,000		50 percent of payments to needy blind (Federal share not to exceed $20 monthly per beneficiary) plus 50 percent of necessary administrative costs.	100
Unemployment compensation administration.	1935	61,000		Amount necessary for efficient administration of approved State unemployment compensation law—determined on basis of population, number of persons covered, cost of efficient management, and such other factors as the Social Security Board finds relevant.	
Public employment offices	1933	3,000		Population	100
FEDERAL WORKS AGENCY					
Annual contributions to public housing agencies.	1937	10,000		Project cost, number of units, persons housed, and other factors.	
Elimination of grade crossings	1936	25,000		One-half population; one-fourth Federal-aid highway system mileage; one-fourth railroad mileage.	
Federal-aid highway system	1916	99,990		One-third area; one-third population; one-third rural delivery and star-route mileage.	100
Federal-aid secondary or feeder roads	1936	15,000		do	100
Public land highways	1921	1,000		Unappropriated public lands, etc.	
U. S. MARITIME COMMISSION					
State and municipal marine schools	1911	190		Maximum $25,000 per school.	100
VETERANS' ADMINISTRATION					
State homes for disabled soldiers and sailors.	1888			$240 annually per inmate.	100

Source: Treasury Department, Combined Statement of Receipts, Expenditures, and Balances of the United States for the Fiscal Year Ending June 30, 1941, pp. 712–714.

(*e*) *Other Federal aids proposed and considered.*

In addition to the well-known proposals for Federal aid for general elementary and secondary schools, a lively issue since 1920, support for the following has been urged: Libraries, recreational activities, eradication of noxious weeds, the education of handicapped children, public pregrade education, engineering experiment stations at land-grant colleges, workers' education, and business and economic research in schools of business in State universities.[90] There appears to be no limit to the activities for which proponents urge Federal Government assistance.

In general, it can be said that the Federal grant system has grown extensively and intensively at a very rapid rate, particularly during the 'thirties. Many critics have hastened to add, however, that the aid system, like many other fiscal institutions, has grown up planlessly and now needs a thorough rationalization. More will be said about this later.

(*f*) *Advantages and disadvantages of aids.*

The principal argument for aids is that they represent an application of the ability-to-pay principle. Aids apply this principle to governmental units in much the same way as it is commonly applied to individuals within a unit. Given a function of general interest, such as education, the ability principle requires contributions by all individual taxpayers according to their means. Given the same general (and diffused) interest among units of government and areas, the same rule can be logically applied to them. The growth of national interdependence supports the case for grants; the nation is compared to the human body, and it is said that some part that doesn't function is like a bad finger or ear, a matter not to be ignored by the organization as a whole.[91] Many of the weaknesses of sharing revenues are avoided by the use of aids. The latter lend themselves to greater central control. In a sense this means a surrender of local fiscal independence, but the degree of surrender is quite flexible and it is confined to matters in which there is a central interest. The proprietary interest in public funds, thought to prevent extravagance in the case of shared taxes, is lacking, but an imposed discipline from the central government more or less takes its place. Aids and shared taxes may be almost identical under certain conditions but the psychology attending the two is usually quite different. Both have this in common: That they seek the benefits of centralized tax administration, while preserving to a great degree the benefits that result from local administration of certain governmental functions.

The aids are objected to on the ground that, spending other people's money, they encourage carelessness and extravagance in the use of funds. It is further contended that, where aids become a major source of revenue in a community, they tend to pauperize the community and to weaken the sense of local responsibility. The case is cited of a community which subsists upon State funds to the extent of 90 percent of its public revenues. It is claimed that aids tend to perpetuate such unnecessary communities—that distress is a natural

[90] V. O. Key, Jr., op. cit., pp. 22-23.

[91] Henry F. Long, "The Case for a Minimum System of Local Government Reporting," State Supervision of Local Finance, Proceedings of a Conference, December 4, 5, and 6, 1941, Municipal Finance Officers' Association, Chicago, p. 57.

symptom of maladjustment, and when it is mitigated by outside financial support, the necessary readjustments may be indefinitely postponed. It can hardly be questioned that aids are sometimes used to finance local functions when it would be wiser to centralize the performance of the functions and to reorganize governmental units. Moreover, most aids involve an element of redistribution, and this feature is often objected to by districts which feel that they are subsidizing their poorer neighbors.

Aids are, however, a product of stubborn economic, social, and fiscal facts, among which may be listed: (1) The developing interdependence of local units, creating general interest in many of what were formerly strictly local functions; (2) the inequalities in financial ability between local districts; (3) the inadequacy of local sources of revenue in view of local responsibilities of government; (4) the superiority of central units in the administration and collection of most taxes; and (5) the unacceptability, and probable inadvisability, of wholesale centralization of governmental functions. The aids persist and grow, not so much because of any arguments as because of certain conditions which make them the best available means to an end.

(*g*) *Forms of aids.*

It is possible to distribute aids in a great variety of ways with very different results. For example, a matching aid, designed to stimulate local interest to the maximum, may have just the opposite effect from an equalization grant; where local units are unable to match centrally distributed funds in any great degree, inequalities may be increased rather than reduced. Sometimes the matching system fulfills the Biblical doctrine: "To him who hath it shall be given." Equalization grants, on the other hand, provide a clear means of reducing territorial inequalities.

"Open end" matching grants, as now employed in the Federal Social Security system, provide for Federal outlays to match those of the States up to a specified maximum, the level of State expenditures, with qualifications, remaining a matter of State discretion. The effects of such a system are not always the same but in the main they aggravate inequalities. However, this takes no account of the tax system of the central government. If the Nation's tax system were sufficiently progressive almost any central distribution to finance what was formerly a locally supported function would be likely to mitigate inequalities.

Aids differ also in whether or not they are conditional, in the sense that they must be for a specific purpose. Among the unconditional aids attracting most attention is the British block grant, providing for the distribution of aid according to need as measured by population weighted (*a*) by the percentage by which the number of children under 5 years of age exceeds 50 per 1,000 population; (*b*) in the proportion that the amount of per capita assessed valuation of taxable property in the unit falls below £10; (*c*) according to the density of the population per mile of public roads, and (*d*) according to the number of unemployed.[92] The block grant resembles sharing in that it leaves local governments free to spend at their own discretion. It differs in not returning revenues to the place of collection.

[92] See Mabel Newcomer, Central and Local Finances in Germany and England, Columbia University, New York, 1937, pp. 161–290, for a more extended treatment of this act.

The history of intergovernmental fiscal relations in Canada affords an example of a sporadic application of specific grants and a long standing application of general grants from the Dominion to the Provinces. However, the Canadian unconditional grants have proved rather inflexible, poorly adapted to needed central controls, and an easy medium for continual political bickering. J. A. Maxwell, who has made a thorough historical study of Canadian experience,[93] came to the conclusion that unconditional grants had worked very badly and should be abolished. Nevertheless, at the hearings before the Royal Commission, few if any of the spokesmen for the Provinces advocated conditional grants. Instead they recommended a reallocation of functions and a readjustment of unconditional subsidies.

(*b*) *Administration.*

As stated above, one of the advantages which the grants-in-aid have over shared taxes is that the former carry greater possibilities of control and of conserving funds, by insuring that the aids are spent effectively upon the designated purposes. The early Federal aids, particularly the land grants, were not attended with any adequate machinery of supervision and the results were notoriously bad. Current techniques of Federal control and supervision[94] include required reports of operations and receipts and expenditures; the withholding of funds to check abuses; the auditing of accounts and inspection of performance; advance review and approval of plans of expenditure; requirements concerning State machinery of administration, including personnel; and informal conference and advice. Aid legislation sometimes requires certain experience and training in State personnel selected to administer the expenditure of funds. The aid for State employment offices went further and required the merit system of appointment, although some of the original conditions were later modified. In general, the application of administrative controls leaves plenty of room for improvement, but the trend has been toward more effective control and there can be no doubt that the aids have exerted a salutary influence on the quality of State and local administration.[95]

Whether or not it would be possible, with an extension of the Federal-aid system, for the Federal Government to exert an effective but not too coercive pressure upon State and municipal governments gradually to repair weak spots in their governmental machinery and practice, remains a matter of speculation. Among the gains which readily suggests themselves are the following:-

1. Consolidation of superfluous governmental machinery.
2. More even division of educational revenues between whites and Negroes.
3. Better adaptation of municipal governmental machinery to metropolitan needs.
4. Better administration and distribution of State grants-in-aid.
5. Elimination of the "rotten borough" system of representation in State legislatures.
6. Continued improvement in State and local methods of selecting personnel.

[93] J. A. Maxwell, Federal Subsidies to the Provincial Governments of Canada, Harvard University, Cambridge, 1937, pp. 255-256.

[94] V. O. Key, Jr., op. cit.

[95] Oddly enough, the history of conditional grants in Canada indicates little effective Dominion control, and the trend has been generally in the direction of less effectiveness. See Luella Gettys, The Administration of Canadian Conditional Grants, Public Administration Service, Chicago, 1938.

(*i*) *Possible improvements in the Federal-aid program.*

Mention has been made of the fact that the Federal-aid program has been improvised during the pressures of an emergency period and needs rationalization. What are the lines which this rationalization should take?

First, and probably most important, the present aid program is defective as to coverage. The preferred position given to certain Federal purposes as compared with others is not defensible. Just why the Federal Government should expend funds raised from general taxes to promote vocational education and not general education, or old-age assistance but not general relief, is not at all clear. The present system has the effect of throwing local budgetary relationships out of balance. It is observed that in New York the 1939 expenditures for relief were 4 times, and in New Jersey 3 times the amount spent for old-age assistance. In Massachusetts, Wisconsin, Minnesota, and California, the amounts were about the same, but in Oklahoma, Texas, and Colorado, the old-age-assistance outlays amounted to from 5 to 20 times those for relief.[96] While these differentials can be accounted for to some extent by territorial differences and organized pressures, the phenomena are mainly explained by the unequal Federal support. The poorer States so extend themselves to take advantage of Federal aid in the case of certain services that they have quite inadequate resources to cover other equally important obligations.

The whole welfare problem is so much a matter of causes and effects beyond local boundaries that no one part of it seems much more logically suited for exclusive local responsibilities than another. The children whose fathers are unemployed are just as important to the Nation as those who are fatherless.

While it is probably too much to expect a Federal-aid system to accomplish all these reforms in State and local government, they might prove useful in the elimination of at least some of the abuses. A judicious combination of persuasion and coercion, such as an aid program can embody, offers great opportunities for the improvement of local governments. Cooperation in a mutual enterprise rather than subordination to centralized power can and should be the keynote of such programs. Outside criticism is a highly useful influence in the operation of any government. It is unfortunate that the Federal Government is not in a position to benefit from the same salutary influence.

There is strong feeling against any extension of the Federal-aid system and particularly against a commitment to apply the system to general education. The opposition stems about equally from the fear of regimentation and from the fear of extravagance. There are those who believe that widespread participation by the Federal Government in the educational field would be as unpopular and unsuccessful as our experiment with national prohibition. Undoubtedly, this view is entitled to consideration. But the other side of the picture—the importance of education for citizenship, the diffusion of the results of inadequate opportunity, the widespread inequalities and other limitations of a local educational program—seems more compelling. On the whole, the case for broadening the Federal-aid program to include education is strong enough to warrant action by Congress as

[96] J. P. Harris, "The Future of Federal Grants-in-Aid," Annals of American Academy of Political and Social Science, vol. 207 (January 1940), p. 19.

soon as the present emergency is past. The case for the extension of the aid system to relief and its increased use for public health also appears convincing.

Rationalization of aids should include broadening and equalizing of grants among functions. Would this convert conditional aids into an unconditional block grant? This might be the result, but it seems quite possible to increase the aids considerably without creating a number so unworkable that a composite index would be preferable.

As previously stated, it is important that future Federal-aid policy give a large amount of attention to administration and to the improvement of State and local government techniques of operation. The accomplishments of the Bureau of Public Roads and the Social Security Board in improving State and local governmental operations are distinctly encouraging and extension of controls of this sort, possibly by persuasion rather than compulsion, offers prospects for the future that should be exploited as much as possible. For example, it would be unfortunate if Federal aid for education were undertaken without making an effort to secure a better organization of school districts and a better division of funds between the white population and Negroes. In this case, however, it is necessary to give assurance against regimentation and the suppression of minority views and wishes.

Finally, more attention needs to be given to methods of apportionment. For aids of small amounts, population may be a satisfactory basis of apportionment. But it is only a very rough measure of need. More refinement is required for larger grants, and this raises the question of differential or equalization aids.

The argument for differential aids rests heavily upon the claim that there is a Nation-wide interest in maintaining fairly uniform standards in the performance of certain functions such as education and public welfare; and that only through such aids can this be brought about, at least without unduly burdening local taxpayers. The case for differential Federal welfare aids is strengthened by the fact that some of the poor States have been obliged to curtail other important public services in order to meet their responsibilities under certain provisions of the social-security program. Many proponents of Federal aid for education argue, on similar grounds, that such aid would be more effective if apportioned on a differential basis.

On the whole, it seems best to confine a differential equalization aid program, at least in its earliest phases, to cases where a strong interest in a national minimum is clear. Certainly there is a strong national interest in the maintenance of some minimum standards in education, particularly elementary education. Accordingly, there is a clear advantage in including equalization features in any Federal-aid-for-education program which may be inaugurated. The case for a national minimum and equalization grant as applied to welfare is also strong, but here the standards are necessarily relative to the general level of wealth and income in the States. It seems best to start a national minimum program in the field of education from which it might be extended to aids for dependent children. Old-age assistance has a lesser claim to a national minimum status than either of the other two functions mentioned above.

A very desirable compromise for aids in the welfare field, and one which would provide a degree of equalization, would be a graduated bracket system of distribution.[97] Under this scheme the Federal Government would contribute a larger proportion of the assistance granted clients up to a certain standard, and a lesser proportion thereafter. This avoids difficulties of a differential distribution formula, asserts the national interest in bare minimum standards, and encourages intrastate equalization.

It is apparent that the techniques for granting aids are by no means perfected. Existing methods of cost-sharing and matching leave much to be desired. What is needed in a system which will do the following:

1. Insure the performance of a given function according to a certain standard instead of emphasizing, as at present, the mere expenditure of money;
2. Preserve incentives for economy;
3. Avoid freezing existing inequalities in State support of national interests;
4. Assure a reasonable amount of local effort in support of such national interests.

An equalization grant based on a combined index of need and ability, and requiring local expenditure in terms of a percentage of per capita income above a certain allowance for the necessities of life, would meet the last two requirements tolerably well. As to the first two requirements, it is preferable that they be met by adequate administration and controls rather than by any formula for distribution. Certainly these objectives can be given more emphasis in the aid program.

On the other hand, the perfection of measurement for an initial Federal distribution, except as a political excuse for delaying action, is by no means as important a matter as intrastate distribution and the solution of related problems. A perfect formula for the distribution of Federal aid would be frustrated in considerable part were the present secondary distribution systems within States to continue without modification.

(j) *Problems of measurement in a differential aid system.*

Differential aids involve many difficulties. The most important of these is to arrive at a measure of ability and need which can be clearly stated in legislation and which is based on a defensible measurement of facts. For instance, Federal aids could be distributed in inverse proportion to per capita income, per capita wealth, or per capita expenditure (sales). There is little merit in using either of the latter two, however, since they are at best indirect measures of the generally accepted test of ability—per capita income; and per capita income figures are available annually, and are somewhat more reliable than those for wealth, and more frequent than either wealth or expenditure figures. However, even here there is a dispute as to whether it is income produced in a given State or income received by the residents of the State that should be used. Moreover, local finances are necessarily very largely supported by the property tax, and the basis of such a tax may not correlate very accurately with income data. Income data as to local units are almost nonexistent, though the reduction in exemptions in the Federal income tax might supply more and

[97] S. 3030 (a bill to provide a larger Federal contribution for old-age assistance), 76th Cong., 3d sess., January 4, 1940 (Senator Connally)

better information than is now available. In addition, income-payment figures take no account of the distribution of income among individuals, of differences in the source of income (wages, property, natural resources), or of differences in the cost of living. Moreover, the figures now available do not include items of imputed income (rental value of homes), and insufficient allowance for Federal taxes is made. Recent studies indicate that there would be less difference than might be supposed in State rankings under varying criteria of measurement.[98] But they are not negligible. Nevertheless, none of the limitations on per capita net income received offer a conclusive argument against using it as the basis for the distribution of differential aids.

The Social Security research staffs have tended to favor per capita income payments as simple and dependable basic data for measurement of relative State fiscal capacity in connection with variable grants.[99] Total income payments to persons are considered to be an over-all measurement of the aggregate funds from which States must draw their revenues during any given period of time. The denominator, total population, reflects the size of the group which income payments must support; hence per capita income is the best single basis upon which to compare the capacities of the States to finance public services.

Proponents of the per capita income measure admit that quantitative data are far from perfect, and state that absolute precision is impossible, since the many qualitative factors cannot be incorporated in quantitative objective measures readily adaptable to administrative use. Since it is considered desirable, however, to incorporate simple and available objective measures in Federal variable-grant statutes, the per capita income data are favored in spite of their limitations.

Considerable effort to measure fiscal capacity and use such a measure as a basis for aids has also been exerted by those interested in Federal support for education. Several critics have favored the estimated yield of a uniform tax plan as a basis of measurement of relative taxpaying ability.[1] Others have attempted the use of various economic series such as value added by manufacture, farm cash income, postal receipts, and so forth. (First application of this technique was made by the Federal Emergency Relief Administration as a guide for distributing Federal relief funds during the middle 'thirties.)[2] Others have favored a combination of these two approaches.[3] The yield of a model tax system or selected taxes is open to the objection that it is highly subjective as to the choice of taxes. The use of economic series is open to this objection also. On the

[98] Paul Studenski, Measurement of Variations in the Fiscal Capacities of the States, Social Security Board, Bureau of Research and Statistics, 1942 (unpublished).

[99] Cf. Social Security Board, Fiscal Capacity of the States: A Source Book, 1941.

[1] Leslie L. Chism, The Economic Ability of the States: The Ability of the Various States To Raise Tax Revenues Under a Plan of Taxation Based on the Model Plan of State and Local Taxation, With Special Reference to the Relative Ability of the States To Support Education, Teachers' College, Columbia University, 1935; Mabel Newcomer, An Index of the Taxpaying Ability of the States and Local Governments, Teachers' College, Columbia University, New York, 1935; Paul R. Mort, Federal Support for Public Education, Teachers' College, Columbia University, New York, 1936; The Efforts of the States To Support Education, National Education Association, Research Bulletin, May 1936, p. 114.

[2] E. A. Williams, Federal Aid for Relief, 1939; J. Roy Blough, "Equalization Methods and Distribution of Federal Relief," Social Service Review, vol. IX, No. 3, September 1935.

[3] P. R. Mort and E. S. Lawler, Principles and Methods of Distributing Federal Aid for Education, Staff Study No. 5, Advisory Committee on Education, 1939, p. 49; J. K. Norton and M. A. Norton, Wealth, Children, and Education, Columbia University, New York, 1938.

score of simplicity and objectivity, the per capita income method has quite convincing advantages.[4]

(*k*) *Conclusion.*

The aids are sometimes referred to as an expenditure coordination device rather than a means of tax coordination. It is proper to think of these transfers as both tax relief and subsidized expenditures. Some of the strongest support for aids comes from those who see in them a means of relieving local tax pressures.

That Federal aid is a coordination device destined to a large future development seems assured. As one writer has put it, this institution is "peculiarly adapted to the needs of Federal countries." [5] But the development of more refined techniques in the use of this device will present a challenge for many years to come.

9. REALLOCATION OF FUNCTIONS

In the situation now prevailing, where the central units of government enjoy the greatest fiscal powers and the local units have direct responsibility, for the most part, for highways, education, welfare, and other important functions of government, it seems logical to anticipate a centralization of functions. The logic is reinforced by the growing national interest in what were formerly regarded as strictly local concerns. But the logic encounters resentment from those who feel that concentration of political control need not follow an economic concentration. Centralization in various forms is taking place, but it proceeds slowly, resisted by tradition, vested interests, Constitutional impediments, as well as some reasonable objections.[6]

10. CONSOLIDATION OF LOCAL GOVERNMENTAL MACHINERY

Some critics believe that the principal trouble with American governmental machinery at the present time is that there is too much of it. They hold that units which were devised during entirely different economic and social conditions are no longer suited to perform modern functions efficiently and economically. Some have admitted the importance of some decentralization in government and have visualized the reorganization of local governmental machinery as a way to preserve decentralization by making it more effective. The problem of effective governmental machinery is viewed by William Anderson as a conflict of opposing interests as follows:

> The simple fact is that the American people have desired two things which seem to be incompatible. One is complete local self-government in a system of small units coming down from earlier days; the other is a standard of services higher than ever before and a distribution of expenses over wide areas, so that no local area, especially not a poor one, will be unduly burdened. The local areas and institutions that we have inherited have shown themselves to be very poorly adapted to the rendering of the desired services, and they were entirely too small to give the desired spreading of the tax burden.[7]

[4] But it is important to recognize that the ability of some States to tax the income credited to other States makes this an imperfect measure even if per capita income is otherwise a satisfactory test of the States' ability to contribute to the support of such activities.

[5] J. A. Maxwell, Federal Subsidies to the Provincial Governments of Canada, pp. 255-256.

[6] For further discussion of this means of coordination, see sec. C, infra.

[7] William Anderson, Local Government and Finance in Minnesota, University of Minnesota Press, Minneapolis, 1935, p. 327.

Concerning the centralization issue this critic observes:

> With competence restored to the local units through enlargement, reorganization, and improved personnel, the rush of functions up to the state and national capitols will be checked, and the enlarged local units because of their increased ability and effectiveness, will not require constant supervision from the center.[8]

Professor Anderson has outlined what he regards as a model system of simplified local governmental machinery replacing our present 165,000 units with 350 city-county units, 2,000 rural counties, and 15,000 incorporated places and miscellaneous units.[9] One can hardly doubt that the suggested model would be a vast improvement over what we now have to work with. But it is difficult to graft a new mechanism upon a going concern and progress in the direction of reorganization, except perhaps in the case of school districts, has been so small as to be properly described as negligible. Just what economies one might expect from a reorganization program, were it entirely successful, are not easy to demonstrate, but that they are sufficient to warrant continued effort in the face of discouraging results can hardly be doubted.

Reorganization of governmental structure ranks with coordination of tax systems as a subject of much talk and little action. Probably the economies claimed for the former are exaggerated. Government in the South is quite centralized, and the county is often the principal unit for the performance of the functions of education and highway construction. That local government in the South is conspicuously more economical than elsewhere has never been demonstrated. Consolidation is not a panacea and it is an exceedingly difficult road on which to make progress. But there can be no doubt that "where there is so much smoke there must be some fire." A strong argument against an extension of the aid system is that it tends to perpetuate submarginal communities. The proponents of this argument seldom make it clear how, without the aids, these marginal communities would be liquidated. But it is important to reexamine and press for rearrangement of district divisions as a feature of a central aid program.

C. Functional Approach to the Problem of Intergovernmental Fiscal Relations

1. INTRODUCTION

The fiscal problem can be approached from either the angle of taxation or of public expenditure. It should always be remembered that taxes are but one face of a shield of which services and expenditures are the other side. Overlapping taxes are paralleled by overlapping expenditures, and the trend is toward more overlapping rather than separation of responsibilities. As to the four major functions of government (protection, highways, education, and welfare) all levels of government are considerably involved either in provision of financial support or administration or both. This participation follows a wide variety of patterns including a division of the field as in the case of protection; Federal financial support, with mainly State and local

[8] Ibid., pp. 327-328.

[9] William Anderson, The Units of Government in the United States, Public Administration Service, No. 42, Chicago, 1936, p. 36.

administration in the case of highways; and mixed patterns in the case of education and welfare.[10]

If the Federal Government had a monopoly on all the functions of government, it alone would be obliged to levy taxes and there would be no problem of coordinating Federal and State tax systems. But many would hold the remedy in this case worse than the disease. From a very early day, a controversy has raged concerning the respective spheres of the Federal Government and the State governments. The spheres, particularly in recent years, have been quite elastic. While space does not permit an elaborate treatment of coordination by shifting of functions, some attention to the general aspects of this problem may be given here.

It has been said that, in our modern era, states tend to evolve from a league of nations to a true federation to a unitary state. This is said to be demonstrated by the experience of Switzerland, South Africa, and Germany. Exceptions are observed in the case of the British Empire and in the home-rule-for-cities movement. Undoubtedly, the preponderant tendency, for better or for worse, is toward centralization and a unitary state.[11] The tendency, and perhaps the logical outcome, has been presented by one observer in terms of an amusing figure of speech.[12]

> At its inception then, the federal union is always a marriage of convenience—a practical business-like arrangement with no sentimental nonsense. The parties insist upon retaining their separate identities and personalities; they do not become one flesh. Of course, with the passing of time and the running of a common household, the marriage of convenience may be transformed into the kind of marriage that is made in heaven where the identities of the several states are merged in an indissoluble united nation. When this happens, the desire for a genuinely independent status in the several states will probably wither away. There will be no substance left in federalism if it does.

It is by no means universally agreed, however, that more centralization is inevitable, much less that it is desirable. Nor is it clear that more centralization leads necessarily to the abandonment of federalism. It is fairly clear that centralization would provide a partial solution of the problem of tax coordination.

[10] Concerning the division of governmental functions in other federal systems the following is submitted:

The States ordinarily have been left with full responsibility for internal order, education, highways and welfare. (The Union of South Africa is an exception in that police protection is the responsibility of the Union). For Canada it is expressly stated that the Provinces shall have exclusive power over education (art. 93), and charities and charitable institutions (art. 92 (7)).

The special protection of Provincial powers in this case arose from the conflict of nationalities and religions which was more pronounced in Canada than in most of the federal governments under consideration.

Except for problems of settlement, relief was regularly left to state control when the federal governments were established. Education was the responsibility of the states with the following exceptions: Switzerland authorized the federal government to establish or subsidize institutions of higher learning and to require the Cantons to provide free and compulsory education (art. 27). An amendment of 1902 provides Federal subventions for the Canton schools. Brazil and the Union of South Africa also authorized the establishment of national institutions of higher learning, and the latter provided for subsidies for primary education (Brazil, art. 35 (3); Union of South Africa, art. 85 (3), art. 118). The only important provisions for Federal control and financing of highways deal with interstate and international highways. Such provisions are found in Switzerland (art. 30), Canada (art. 92 (10a)), and the Union of South Africa (art. 85 (VIII)). The German constitution went further, charging the Federal Government with the construction of "land and water ways for purposes of public defense, and of general commerce" (art. 4 (8)).

[11] Recently China in its "New fiscal policy of 1941" adopted a program of centralization. All Provincial assets and liabilities were to be taken over and all Provincial revenues and expenditures were to be administered by the National Government.

"The 'hsien' (county) government is to be regarded as financially autonomous and its expenditures are to be financed out of stamp-tax revenues and by 25 percent of the inheritance tax and 30 percent of the business tax of the district.

"The land tax hitherto collected by the Provincial government is to be collected by the National Government in kind, by taxing 10 kilograms of rice, wheat, or other cereal in place of 1 yuan at current tax rates.

"All Provincial transit taxes are to be abolished * * *"—(Letter from the Chinese Embassy, Washington, May 20, 1942).

[12] J. A. Corry, "The Federal Dilemma," Canadian Journal of Economics and Political Science, May 1941, vol. 7, p. 216.

While the tax coordination movement has moved from one impasse to another, the expenditure and functional side of the fiscal coordination problem has remained fluid and has evolved fairly steadily, except for the great acceleration of pace during the depression of the 'thirties. During this latter period, the Federal Government took on and successfully maintained, after some initial losses in court, the following major innovations:

1. An extension of the commerce power to include a broad range of policing of our economic institutions. The Labor Relations Act and Wages and Hours Act are examples.
2. Assumption by the Federal Government of direct and indirect responsibility for welfare including social security.
3. Inauguration of extensive use of Federal credit (Reconstruction Finance Corporation, United States Housing Authority, Farm Security Administration, and so forth) to finance State and local projects and public and private corporations.
4. A promotional role in agriculture and (through fiscal policy) industry; from the individual's standpoint, this involved something like an attempt to underwrite an economic minimum of opportunity and well-being through government.

It need hardly be emphasized that these were innovations of revolutionary significance. The highly charged political atmosphere of the 'thirties is evidence that the developments were by no means free from controversy.

As previously stated, it would be a mistake to assume that the expansion in the Federal sphere has been all at the expense of the States and their subdivisions. The States retain most of their traditional functions, though their relative sphere and prestige has undoubtedly suffered. Whether Federal expansion has been justified in all cases is, of course, debatable but for the most part the changes seem warranted both by economic facts and emergency conditions.

2. CENTRALIZATION VERSUS DECENTRALIZATION

(a) *The division of ranks.*

The division of ranks on questions of centralization versus decentralization is not easy to explain. Many liberals feel that centralization is synonymous with progress and that centralized political power must displace centralized economic power. Decentralized institutions are thought to be inefficient, and the confusion and frustration resulting therefrom may lead to the discredit and overthrow of democracy. This mode of thought is somewhat, though not exclusively, identified with the Marxian tradition. On the other hand, some liberals hold that centralization in any form is dangerous and inimical to important values, especially those of a non-economic character. This view stems mainly from the antimonopoly school of American thought. The conservatives are also split on the matter. Some favor economic centralization as a step toward greater economic efficiency and feel that the same rule holds for government within a properly limited sphere. Others are opposed to governmental centralization while favorable to economic centralization. They are interested in a free hand for business leadership in the economic sphere and a minimum of effective governmental interference of any kind. Other conservatives join with the antimonopoly liberals in the view that society preserves a better balance and greater realization of more important values if a high degree of centralization is avoided.

(*b*) *The values of decentralized government.*

Throughout American history there has been a consistent fear of centralization, and periodically the present or prospective size of the Federal Government has become the concern of many persons. Democracy and decentralization have been quite freely identified. The feeling that there are values in decentralized government which should be preserved may be analyzed into the following elements:

(1) It is felt that centralized power involves the danger of becoming autocratic power. There is a genuine fear of what is termed "the specter of federation and the authoritarian state."[13] One way of stating this belief is that it is easier to execute a coup d'etat in one capital than in 49. As previously stated there is a strong belief, in the United States, in safety in numbers. A decentralized system tends to isolate strong tendencies of national minorities to infringe upon civil rights. While the point may have some validity, it is at least doubtful if it should be given much weight.[14] On the other side of the issue, it may be said that revolutions are most likely to develop out of frustrations, and that national governments, with their superior powers of economic control, provoke rather than avoid violent changes, by assenting to a wide decentralization of power to governments in no position to use it effectively.

(2) It is held that local units have a strong proprietary interest in tax resources, and that the broader the radius of the field in which tax collection takes place, the weaker becomes the urge to economize. Central units lose the discipline that goes with the sense of ownership in revenues. All government is to a degree a case of spending other people's money. Moreover, the central unit is able to tap the money-creating mechanism at will. Proprietary interests are probably insufficient in any case, under modern conditions, to preserve economy. We must develop other checks and disciplines to prevent wastage of resources through government.

(3) Centralized government tends to ignore diversities of interest and points of view. Legislation that covers a big country is likely to make insufficient distinction for rural and urban, black and white, Catholic and Protestant communities. Opinion differs as to the range of diversity in the United States. Wide-scale communication, advertising, and circulation of reading matter have had a unifying effect on public attitudes. But differences of a physical and economic character and specification as to economic function operate to maintain important differences. Labor and tax legislation well adapted to New York may seem quite inappropriate in North Dakota and Mississippi. This diversity of conditions is what has prompted statements like the following:[15]

> Our Federal system is the only form of popular government that would be possible in a country like ours, with an enormous territory and 100,000,000 population.

[13] Henry C. Simons, "Hansen on Fiscal Policy," The Journal of Political Economy, vol. L, No. 2, April 1942, p. 189.
[14] It may be noted that the German Republic was a more decentralized government than the French.
[15] William H. Taft, Popular Government, Yale University Press, New Haven, 1913, p. 145.

While some New Deal agencies, such as the Work Projects Administration, have attempted some differentiation within Federal policy, their standardization of rules and procedures has been one of the most criticized aspects of such national programs.

(4) Decentralization facilitates experimentation. While uniformity is the watchword of many, diversity also has its advantages. It affords the opportunity of trying out innovations in government without the heavy risk of wholesale Federal application. It is easy to recall a fairly large number of State and local innovations which can be classed as experimental. Selecting a few at random, there is the unicameral legislature in Nebraska; a variety of direct primary voting systems; proportional representation; State automobile insurance in Massachusetts; and the deductibility of medical expenses in the Minnesota income tax. Of course, it can be said in rebuttal that the States and their subdivisions might have shown more initiative in experimentation. Innovation has been fortuitous rather than planned, has been based on very little research in some cases, and is not always widely copied when it is successful. But the opportunity for experimentation afforded by the States and subdivisions is not to be lightly discarded as of small value. The so-called "deadly uniformity" of Federal control is a limitation, and perhaps to some degree a necessary limitation, to a centralized system.

(5) A decentralized system affords the widest opportunities for citizen participation and the development of sound civic attitudes and leadership. A study of the membership of the Seventy-third Congress disclosed that 35 Senators and 149 Representatives, 34 and 35 percent of the respective totals, had served apprenticeships in State legislatures.[16]

One would dislike to think that it is necessary for a young person to go to Washington in order to exercise and develop a natural talent for leadership in public affairs and in order to do anything effective about improving the public order. It is quite easy for interested people to make themselves heard on legislation pending in the State capitol or city council; much more difficult in the case of national legislation. Harold Laski and others have urged more local autonomy as a means of revitalizing local governments in Great Britain. Most people go through life without exercising any position of public trust, not even that of a school district clerk or board member. It would be a great loss were men of vision and creative ability to be persuaded that it is no longer worth while to run for State and local office or to stay in State or local jobs. The intangible value of this participation is quite difficult to measure, but undoubtedly it is substantial.

The democratic values in participation have been defended by one critic as follows:

> Of course participation by private citizens in the governing process slows things up. The democratic way takes more time. It is quicker to give a command than to reach an agreement in a conference. It takes much less time to issue an Executive order than to put a bill through two houses of a legislature with public hearings in both houses. A full jury trial in court takes much longer than the summary action of a secret tribunal. And it may take longer to get a given type of law passed in all 48 States than in our national Congress. On the other hand, it should be remembered that such a law may not be needed in all the States, or a different law might be much better in some of them. And some States could possibly pass a much better law than any which could be passed in Congress. In

[16] John Brown Mason, "181 of Us in Congress," State Government, vol 7, June 1934, pp. 126–128.

any event, speed is not the main criterion. There are many short cuts in government that we cannot afford—the price is too high.[17]

(6) Finally, centralization tends to develop inefficiencies of operation. One commonly hears arguments for national control on the ground that large-scale business requires equally large government for effective control. But it is by no means established that business itself is not frequently overgrown, either for maximum efficiency or from the standpoint of other criteria of the national interest. Accepting this view, should one argue that having allowed too much of business to become too large we must now proceed to do the same with government? Large government and big business have the common limitation that they forbid an intimate knowledge of detail on the part of chief administrators and those in charge of legislative policy. A staff of 1,000,000 public servants may be judged unwieldy and unmanageable. Coordination becomes a major problem in an organization of this kind, and the task is intensified by the fact that a large government has to keep a large force in the field to cover a large territory. In the case of democracy, the growth of centralized government throws a heavy task on the voter who is expected to pass judgment on a multitude of issues in the casting of a single ballot. It also throws a heavy burden on Congress and the President.

Some of the traditional fear of economic concentration in the United States, originally associated with the antimonopoly movement has been transferred to political concentration in Washington. Whether or not this fear is justified, there are important advantages to a system which permits initiative at many points.

It should be said also that efficiency in the governmental performance of specific functions is still in the astrological stages and has rarely been subjected to scientific unit-cost studies—the only type which might provide relatively convincing evidence. One commentator has described the situation as follows: "In the matter of actual economy, there are few reliable or comparable figures which prove anything. It would be exceedingly difficult to say whether State or local administration was cheaper in dollars and cents." [18] The same generalization would hold for Federal-State comparisons.

(c) *Centralization.*

Of course there is much to be said on the other side of the centralization issue—the States have a limited perspective and power in attempting to control large-scale interstate business, the business cycle, and the trend of national income. Previous mention has been made of the oft-repeated charge that the States are notoriously negligent and inefficient in performing the genuinely constructive action which the times require. The accusation has some validity, but, viewed in historical perspective, initiative seems to depend considerably upon leadership and in this respect the Federal Government seems to have had no consistent advantage. Perhaps the most sensible conclusion is that, because of the values stated above, there is a presumption in favor of decentralization. However, the presumption is by no means conclusive and the urgency of national objectives has to be weighed in each case against the values lost by centralization.

[17] Elizabeth Brandeis, Centralization versus the Democratic Way in Unemployment Compensation and Elsewhere. Unpublished manuscript.
[18] H. F. Alderfer, National Municipal Review, vol. 27, April 1938, p. 194.

Whether we like it or not, the trend toward centralization is likely to go on irresistibly. The great fiscal resources of the Federal Government, with its large taxing and monetary powers, its superior strategic position in managing the economic system as a whole, the growing urge for minimum standards, and the interest in uniformity with developing interdependence, all point toward centralization. The problem is to seek a balance, some independent resources for the smaller units of government, and a genuine interest in the vigor of local government.

3. MEANS OF AVOIDING THE EVILS OF OVERCENTRALIZATION

Retention of powers and activities in State and local hands is only one means of achieving or maintaining decentralization. Another method is the dispersion of authority at the Federal level. Mention has already been made of the fact that 80 percent of Federal employees are located outside of Washington and that many departments have regional offices. Very often, however, this decentralization is more spurious than real. The offices are like the units of a chain store in that no real authority is attached to them. Considerable interest in this respect attended recent decentralization of the Bureau of Internal Revenue. While some authority was delegated to personnel in the field offices, the delegation was by no means complete. Of course, even the geographic decentralization has the advantage that it enables the people to come in contact with their Government's representatives. The participation interest has been most vigorously cultivated by the Department of Agriculture, which in its land-use planning program has attempted to guide and develop local opinion and foster local initiative. Both in its cooperative aspect and its interest in building up local initiative the Department's program deserves watching and copying.

What is known as regionalism, exemplified in part by the Tennessee Valley Authority, is another form of decentralization. This was discussed in the previous section. It affords some possibilities for the future. To be sure, the Tennessee Valley Authority was not mainly the product of local initiative, but it has made considerable efforts to foster local interest and participation, and it has a large element of delegated authority which it exercises in the field.

An element of decentralization can also be found in the use of local officials in the enforcement of Federal laws. Such cooperation was mandatory under the Selective Service Act during the First World War and has had some sporadic application for a long time. It affords an example of a genuinely cooperative approach to the solution of mutual problems, and is among the most hopeful trends in present intergovernmental relations.

4. DIVISION OF RESPONSIBILITY FOR SPECIFIC FUNCTIONS

Had this report been written in 1930, more attention to the inadequacy and inflexibility of the constitutional and statutory division of functions and powers would have been necessary. It would then have been necessary to argue that the Federal Government was quite inadequately endowed with powers the exercise of which was needed to cope with depression, and which it alone had the perspective and size to exercise effectively. As previously explained, this situation has been largely corrected.

Nevertheless, it would be rash to leave the impression that the present division of functional responsibility is in any sense crystallized or beyond criticism. The division is and always should remain in a state of flux and constant adaptation to changes in conditions. In some cases, increased Federal participation is warranted Whether this should be direct or through the grant-in-aid mechanism must be decided in each case in terms of the advantages and disadvantages. To choose a few examples, the Federal Government almost certainly should provide a larger portion of the cost of education. Most of the increased support should probably take the form of a revised and more generous grant-in-aid system. But direct provision of scholarships to insure the full development of talents (on the order of the National Youth Administration allowances) may also have a place in the program. The Federal Government should probably extend its participation in outlays for direct relief. The program under which Federal support is confined to work relief of limited proportions is properly criticized on the ground that it tends to distort the welfare budgets of the municipalities. Whether work relief should take the form of an aid or a direct participation is also a moot point. The evidence, it seems, warrants no departure from the present practice. Greater Federal outlays for public health seem to be overdue; however, there is conflict here between the proponents of health insurance, a direct Federal health program, and grants-in-aid. Probably the last is preferable. Much the same problem arises in the case of nutrition in which some participation has occurred through a direct Federal program (food stamps) that approaches the problem from the supply side.

At the State and local levels, division of financial and managerial responsibility for schools, highways, and welfare is also in flux, with some trend toward centralization, usually quite justified. Unfortunately, there is great scarcity of evidence concerning relative efficiencies of different levels in the provision of services, a scarcity that suggests another pioneer field for research.

Controversy continues over the State sponsorship of the unemployment compensation system. Here the Federal Government has already asserted a very large measure of control, but the existing arrangement is criticized because of the limited scope and degree of State programs. Unemployment is a national problem and important advantages would result from changes which would place the Federal Government in a position to develop its social-security programs as a whole. On the other side, the interest in experimentation, participation, and adjustment of programs to local diversities may be cited. Were the program to be inaugurated now, it is probable that a national system would have the preponderance of advantages. Since the States have been granted the leading role in the system, they should be given time and Federal assistance to demonstrate whether they can handle it successfully. Constant threats to federalize the system will only interfere with cordial Federal-State relations.

5. CONTROL AND CHARTERING OF CORPORATIONS

The question of which unit of government should have the responsibility of chartering corporations, and the control over such corporations that goes therewith, is mainly a matter of the proper division of functions between governments, but it is also a matter of considerable concern to the tax system.

(a) *State powers and competition in incorporation.*

Berle and Means refer to the business corporation as a "major social institution" and its development as a "revolution."[19] "It involves a concentration of power in the economic field comparable to the concentration of religious power in the medieval church or of political power in the national state."[20] The dominant position of the business corporation has been a matter of rather recent development, largely since 1890. Certainly the situation is vastly changed from that which prevailed when it was fashionable to take snuff and powder wigs. At present, the States have the power to grant corporation charters. They have sovereign powers in this respect, and these powers are respected by other States. The fact that a corporation may extend beyond the boundaries of the State that gives it birth and may in fact have only a nominal existence in that State is immaterial; so, also, is the fact that the corporation may be more powerful than the State which gives it birth.

An important element, too, in the question of functional allocation is the fact that State competition is exceedingly important in the chartering of corporations. The location of a corporation's business operations is likely to be a matter of the location of raw materials and markets, but the choice of a chartering State is not so conditioned. Few, if any, factors in our economic life are so exceedingly fluid as that of situs of incorporation. Add to this the fact that the chartering of corporations is of very substantial advantage to a State, that it affords the State some business connected with the granting of the charter, and considerable prerogative to tax, both at the time the charter is issued and thereafter. The result is that the States are singularly helpless to exercise any vigorous, independent control.

The above analysis is confirmed by experience. The competition first appeared when New Jersey, in the 'nineties, perceived an advantage in an incorporation law which allowed corporations large freedom to use the holding-company device for ownership and control in industrial combination. Other States were quick to follow this example. The very small State of Delaware has chartered over 100,000 corporations.[21] The terms under which these charters can be issued are very largely determined by the interested corporations themselves or by their lawyers located in the "charter-mongering" State. But the incorporation laws of all States are affected, and it has been plausibly stated that under modern conditions no State can afford to pass any stringent disciplinary incorporation laws.

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[19] Adolf A. Berle and Gardner C. Means, The Modern Corporation and Private Property, Commerce Clearing House, New York, 1932, p. 351.

[20] Ibid., p. 352.

[21] Testimony of John T. Flynn (subcommittee of the Senate Committee on the Judiciary, Hearings on S. 10, Federal Licensing of Corporations, 75th Cong., 1st sess., p. 50).

(b) Concentration of corporate situs.

The following facts concerning the location of principal executive offices and the State of incorporation for corporations reporting to the Securities and Exchange Commission are quoted from Statistics of American Listed Corporations.[22]

The location of the 1,961 registrants (based upon location of principal executive offices) was highly concentrated in New York and in 5 other States, in which nearly two-thirds of the registrants had their principal executive offices. New York alone accounted for 22 percent of all registrants followed in order by Illinois, Ohio, California, Pennsylvania, and Michigan, which ranged from 9.5 percent to 6.5 percent. New York was the location of principal executive offices of 5 (of the 7) corporations with assets of more than $1,000,000,000 each included in this report, the other 2 being in Michigan and Delaware. The same 6 States accounted together for 88 percent of the registrants with assets of $500,000,000 and over (New York alone: 63 percent); and for nearly three-quarters of the registrants with assets of $100,000,000 and over (New York alone: 39 percent).

Among the 48 States (and the District of Columbia) Delaware showed the largest number of registrants domiciled through incorporation. In all, 557 registrants (or 29 percent of all domestic registrants included in this report) were incorporated in this State.[23]

The reason for this concentration is indicated by the following figures which show that the proportion of registrants incorporated in Delaware has increased steadily since the adoption of the Delaware corporation law in 1899 and with each subsequent liberalizing amendment:

Percent of registrants incorporated in Delaware of all registrants incorporated during each period

Periods of incorporation:		Periods of incorporation—Con.	
Before 1901	1	1921–25	36
1901–10	5	1925–30	51
1911–15	16	1931–35	42
1916–20	27	1936–37	53

As of 1937, 51 percent of the domestic registrants in the financial group [24] and 48 percent of those in the electric light and power holding-company group were incorporated in Delaware. Other industry groups where this percentage was high were chemicals (51 percent) and petroleum refining (50 percent). No clear correlation appears to exist between size and incorporation in Delaware, except that the smallest registrants (assets of less than $1,000,000) show the lowest percentage of companies incorporated in Delaware.

Prior to 1900 the State of New Jersey had offered what were in many cases the most advantageous terms of incorporation. This is reflected in the fact that of the 201 domestic registrants included in this report which were incorporated between 1875 and 1900, 49 (or nearly 25 percent) were incorporated in New Jersey while in subsequent years this proportion tended to decline, falling to 13 percent among registrants incorporated during 1901–10, less than 3 percent for those incorporated during 1911–20, and to 2 percent for those incorporated during 1921–30.

A slight majority (56 percent) of all registrants had their principal executive offices in the same State in which they were incorporated. Except for the smallest registrants (size of total assets less than $1,000,000) which showed a much more pronounced tendency in this direction, coincidence of State of incorporation and location of principal office did not seem to be influenced by size.

(c) The movement for Federal incorporation.

The movement for Federal incorporation of corporations doing an interstate business is not new. Bills to accomplish this purpose were introduced in Congress in 1911 and legislation of this character was supported by Presidents Taft and Wilson.[25] Two events in the New

[22] Securities and Exchange Commission, Statistics of American Listed Corporations, pt. 1, Summary Report, 1940, pp. 25-26.
[23] However, only 37 registrants (less than 2 percent) had their principal executive offices in Delaware.
[24] As stated previously, this group excludes investment trusts, banks, and insurance companies.
[25] Testimony of Senator O'Mahoney (subcommittee of the Senate Committee on the Judiciary, Hearings on S. 10, op. cit., pp. 34, 40).

Deal period greatly affected the importance of the movement. One was the creation of the Securities and Exchange Commission with extensive powers over the issuance and sale of securities listed on exchanges. The other was court decisions which have in effect extended the definition of interstate commerce to include the production of goods intended for entry into such commerce as well as the actual movement of goods. The former makes the regulatory aspects of Federal incorporation legislation less important, the latter makes it more clearly feasible. That the regulatory aspects, including such matters as rules governing the use of proxies, reports, and the relation of directors to stockholders, are still of very great importance can hardly be doubted. In corporation regulation, as elsewhere in our governmental control of the economic system, cost of compliance by interstate concerns could be reduced considerably by the uniformity which Federal incorporation would tend to supply.

But the taxation aspects of corporation charter-making are also of great importance. The State of incorporation gains a considerable tax prerogative by bidding for the location of corporations. That this creates a very inequitable situation in the tax system cannot be doubted. However, as in so many other cases, the inequity has led to important vested interests, sudden elimination of which would undoubtedly cause a shock. It might be necessary for the Federal Government to cushion the shock, were Federal licensing inaugurated, by the collection and distribution to the States of certain centrally collected revenues from the chartered corporations, such as the fees for incorporation. Perhaps temporary compensation might also be made for some part of the loss in corporate stock taxes. The present absentee incorporation practice creates difficulties of multiple taxation that would tend to disappear were Federal incorporation inaugurated. To be sure, something can and should be done about the multiple-taxation problem whether or not Federal incorporation is accepted as a solution.

Legislation requiring corporations doing an interstate business to secure a Federal charter would involve a considerable shock to business as well as to government. Business would be subjected to new requirements and to a new regulatory authority. But that incorporation of companies engaged in interstate commerce is a function which by all sound logic belongs to the Federal Government seems fairly apparent. The corporation involves very large and intricate problems of balancing the interests of security holders, management, and consumers. A wider perspective and a more strategic position than that possessed by the States is required for this task.

CHAPTER III

PROBLEMS OF INTERSTATE RELATIONS

A. Geographical Distribution of Wealth and Income in Relation to the Tax System [1]

1. INTRODUCTION

It is generally recognized that our national economy is characterized by wide differences in territorial distribution of wealth, considerable mobility of economic factors, much interdependence, and a tangled pattern of harmonious and conflicting interests.

2. THEORY OF GEOGRAPHICAL DISTRIBUTION IN RELATION TO THE TAX SYSTEM

(*a*) *Causes of geographical differences in wealth and income.*

If competition were perfect, in the sense that there were no limitations on the divisibility and mobility of factors, little or no geographical differences in wealth and income could continue to exist. Individual differences would remain, but these would depend on personal abilities and not on the locality in which the individual lives or works. The wide departure of the actual from these hypothetical facts shows the unrealistic character of the fictional institution, perfect competition.

Geographic differences are perpetuated by immobility. Some communities may have a high ratio of population to natural resources or other sources of economic opportunity. And the comparative immobility of the population may perpetuate the maladjustment. But this is not the sole cause of economic differences. Under modern conditions, it is exceedingly difficult to measure a community's contribution, and there is no necessary correlation between such contribution and rewards. Bargaining power may be a major factor and monopoly an important element in bargaining power. A tobacco farmer is engaged in a highly competitive field of production, but the tobacco manufacturer, in an industry with a few large units, is engaged in monopolistic competition.

There are other factors that affect geographical distribution of income and wealth. Governmental and political factors may play a part. It is alleged, for instance, that the national tariff policy has protected the manufacturers of the North at the expense of the cotton growers of the South. The railroad-rate structure is alleged to have favored the North and East and discriminated against the South and West. It has especially favored a few large cities, mostly with competitive water transportation. The charge is sometimes made that there is deliberate discrimination to protect the industry of specific areas. For instance, it is charged that Birmingham's steel industry

[1] Based mainly on a monograph prepared for this study: Mabel Newcomer, Geographic Distribution of Wealth in Relation to the Tax System.

has been discriminated against in order to protect the Pittsburgh mills. While no attempt is here made to evaluate these specific charges, it is clear that the Government's economic policies, intentionally or unintentionally, will favor some regions at the expense of others.

Some districts contribute to others in ways not related to the "fruits of labor." Taxes may be levied in one district and their incidence may fall in part outside the district. More will be said concerning this later. The migration of population from the poorer to the richer areas usually equalizes income and promotes the national welfare. It may, of course, equalize wages downward in the community to which the workers go, but there is no certainty of this, and since the largest part of the migration is of young and able-bodied workers, the business interests, at least, will gain by this immigration. It is pointed out in favor of the rural areas, that they are contributing a large labor supply to the cities. One writer has estimated that a net migration of 6.3 million persons from rural regions to cities, during the decade from 1920 to 1930, made a contribution of $14,000,000,000 to the cities (at an estimated cost of $2,000 to $2,500 for rearing a child). This would be equal to the value of the entire wheat crop of this decade plus half of the entire cotton crop.[2]

This migration continues. Urban population increased 8 percent between 1930 and 1940, and rural population increased only 6 percent, although the rural birth rate has continued much higher than the urban birth rate, and the net reproduction rate of the urban population was only 74 percent. The migration from the rural sections of the United States, and especially the South, has replaced European immigration in the city economy. Insofar as this is "surplus" population, the rural areas may gain as well as the urban areas, but the fact that the urban areas attract the population in its most productive period suggests that the latter are the principal beneficiaries. In periods of unemployment, when these workers are a liability rather than an asset, they tend to migrate back to the farm, which attempts to support them in this also unproductive period.

(*b*) *Difficulties of apportionment of the "fruits of labor."*

Most income is not created by a local self-sufficient economy. Our highly interdependent economy is characterized by specialization of factors, and of areas in which the factors work. Leland describes this and its application to taxation as follows:

> The corporate form of business with its specialized areas for raw materials, manufacturing, distribution, finance, management, and other functions makes it hard for political units embracing less than the whole of these activities, or even the whole of one of them, properly to tax the values created by such an enterprise.[3]

When an absentee owner draws rent from a local resource, the income is realized in the district where the owner resides. Does the district which constitutes the situs of the resource have a proprietary claim to this income for tax purposes? Can it be said that either district has the better claim? Much modern wealth is incorporated; this affords an opportunity for division. But this does not relieve the double-taxation problem. The corporation is taxed in one district

[2] O. E. Baker, Rural-Urban Migration and the National Welfare, Annals of the Association of American Geographers, vol. 123, 1933, pp. 86-87.

[3] S. E. Leland, State-Local Fiscal Relations in Illinois, University of Chicago Press, Chicago 1941, p. 5.

and the stockholder in another. Moreover, for the corporations themselves, apportionment of interstate operations is quite difficult. Formulas are available to serve as a basis of apportionment. But such factors as property, pay-roll expenditure, and location of sales office, which are commonly used in such formulas, do not necessarily measure the area of raw-material supply, labor supply, and residence of customers. The whole apportionment process is clouded with obscurity.

(c) *Spheres of interest in public expenditure.*

Mention has several times been made of the fact that what might have been of strictly local interest under a self-sufficing economy becomes of general interest under modern interdependent conditions of living. But there are degrees of interest. The residents of Detroit may be interested in education in the South because many of the future citizens of Detroit may migrate from the South. But Detroit's chances of getting a migrant from any particular school district in the South may not be very great, and other cities may have even slighter chances. Interests are highly diffused and not very definitely measurable. But it can hardly be doubted that interest weakens with distance. Control also weakens or disappears with distance. The citizen of an eastern city can have little control over the efficiency of expenditure for education in Arkansas.

Interests not only weakens with distance but varies with functions. Except as it may become part of a national attack on unemployment, the adequacy of public recreational activities in Detroit would seem to be of little concern to the residents of Boston. But for obvious reasons, the latter city's interest in the former's postal service is substantial.

Of course, interest may be charitable as well as selfish. But the charitable interest, as well as the selfish interest, diminishes with distance. The taxpayers who have been sufficiently schooled in the Christian virtues to accept the principle that wealthy individuals should contribute to the support of their poorer neighbors are not always willing to extend this principle to the support of the poor of the neighboring county—much less the poor of a State halfway across the continent. If any redistribution of income among individuals is acceptable, some geographic redistribution must follow, although it may only be as between one city block and the next, or among neighboring farms. But opposition to geographic redistribution has been more vocal than opposition to redistribution among individuals.

(d) *Perpetuation of "uneconomic communities."*

It is often observed by critics of State- and Federal-aid programs that the attempt to equalize opportunity among districts creates the danger of perpetuating uneconomic communities. It is said that these uneconomic or submarginal communities should be liquidated rather than subsidized. Poverty alone, however, is not an adequate test of a submarginal community. Poverty may result from exploitation. Even if there is no exploitation, poverty may be its own cause; and one boost up may leave the community self-sustaining on a new high level. Also, the task of liquidating a submarginal community is difficult. Real liquidation apparently would consist of resettlement. This might take place voluntarily because of the pinch of circumstances upon the maladjusted population, or it might be undertaken consciously by government. The first solution meets the difficulty that the poorer people become, the less facility they have to move. Initiative, to flourish, apparently requires economic nourishment. Depressed people in depressed areas are likely to be ignorant of opportunity elsewhere even if they have the wherewithal to move, and if they are beneficiaries of relief they hesitate to risk their relief status by moving. On the other hand, if the Government undertakes a resettlement program, it may be confronted with the fact that opportunity is scarce almost everywhere, and few communities are prepared to welcome the migrant.

Liquidation of marginal communities also may refer to the elimination of governmental machinery, in which case it is consolidation and enlargement of governmental units that is contemplated. This may be in order, as previously stated, and might well be pressed on some occasions as a condition for granting aids.

Each submarginal community needs to be studied as a fresh problem. Some such communities owe their status to overpopulation in relation to resources. Some have many farms too small for economical farming. Certainly there is a real problem of securing needed local readjustments as a condition of and as part of an aid program. But there is no simple solution.

(*e*) *The balance sheet of expenditures and taxes.*

State reports and commentaries on the Federal fiscal system frequently publish tables showing taxes raised in various communities in relation to aids to, and other governmental expenditures in, these same communities. The implication, if not the stated conclusion, is that where the former exceeds the latter, the community concerned is being exploited—obliged to play "Santa Claus" to the politically more fortunate communities. The soundness of this analysis is quite dubious. Central governments should spend money, whether by aids or otherwise, only upon functions of general interest. Once the general interest is conceded, the point at which the expenditure occurs becomes more or less irrelevant. One might equally well protest the contribution of a wealthy bachelor to the school system. The immediate benefit to this individual may be slight, but it is the consensus that education is of general interest to the whole community, and that all are expected to contribute, each according to his ability or otherwise.

Nevertheless, interest in these balance sheets continues and the interest probably does have some reasonable basis. Certainly, if an objective of the fiscal system were to equalize wealth geographically, it would be conclusive evidence of the failure to achieve the objective if facts were submitted which proved that the Government took in taxes more from the poor States than from the rich and paid out in aids more to the rich States than to the poor. Probably most people believe that Federal-aid expenditures are in inverse proportion to State wealth. Some such inverse relationship is found for the 1940 expenditures among the wealthy and middle-income States (table 23). But the poorest States received less per capita than the middle-income States, largely (but not entirely) because of the matching provisions of the social-security grants. It is a striking fact that Nevada, with the highest per capita income, receives Federal Social

Security aids per capita that are twice those for the entire country. Nevada also fares very well on highway aids and has had a generous quota of Civilian Conservation Corps and Work Projects Administration expenditures. Apparently, the Federal Government applies the principle of taxation according to ability more effectively than that of expenditure according to need.

It will be recalled that 12 leading manufacturing States received 60 percent of the early defense contracts. But it is important to add that these contracts had to be allotted in such a way as to get the job accomplished quickest and best. The need of the States could be given only minor, if any, attention in this distribution.

(*f*) *Harmony versus conflict of interest.*

It is not always easy to know when it is good business to be "your brother's keeper" or, for that matter, when the latter course is even intelligent philanthropy. It can be said at once that special favors to regions in the form of economic advantages politically bestowed (such as unequal opportunity in transportation rates) are of doubtful defensibility from the social point of view. The same conclusion might not follow, however, with regard to taxing the North and East to raise educational or welfare standards in the South. With increasing emphasis upon consumption and markets in the economy, the case for recognition of a national minimum becomes constantly stronger. Probably the degree to which interests are in harmony is not fully appreciated. One section of the country may profit for a time by the exploitation of another. But if the situation continues, the first section may lose its market or its source of raw materials. Modern interdependence is very great and increasing.

3. EVIDENCE CONCERNING GEOGRAPHICAL DISTRIBUTION

(*a*) *Variations in per capita income and wealth.*

The problem of equalization is created by the fact that variations in wealth and income from one part of the United States to another are great. These variations increase as the country is divided into smaller and smaller areas. If the country is divided into only 6 regions, using Odum's grouping of States, the per capita wealth and income in the richest region is between 2 and 3 times that in the poorest region. This is shown in tables 5 and 6. If the 48 States are used as the basis of calculation, the variation in per capita wealth and income increases materially; in fact, it is so great that the average income in one State is not even an acceptable relief standard in another. To illustrate, the average old-age pension in California in 1939 was $345.[4] This exceeded the per capita income in 10 States in this year; it exceeded the per capita income of the poorest State by 70 percent.[5] When States are subdivided into several thousand local jurisdictions, the variations in income and wealth are much greater, as the data in tables 5 and 6 indicate.

[4] Computed from data in Social Security Board, Trends in Public Assistance, 1933-39, 1940.

[5] The State with the lowest per capita income, Mississippi, has a larger proportion of children than most States, and these do not require as much income as old people in order to maintain an adequate minimum standard. If the Mississippi income is divided by the population 14 years of age and over, however, the per capita figure is still only 80 percent of the California pension.

TABLE 5.—*Variation in per capita wealth in selected taxing jurisdictions in the United States*

Jurisdiction	Per capita wealth		
	High value	Low value	Ratio of high to low
6 regions, 1930[1]	$4,519	$1,663	2.7 to 1.
48 States, 1930[2]	7,264	1,298	5.6 to 1.
316 Massachusetts towns, 1935[3]	10,736	407	26.4 to 1.
1,624 Illinois townships, 1938[4]	11,720	365	32.1 to 1.
932 New York towns, 1929[5]	15,956	370	43.1 to 1.
11,378 Illinois school districts, 1934[6]	352,109	357	986.3 to 1.

[1] The regions are those described by H. W. Odum, Southern Regions of the United States, Chapel Hill, 1936, pp. 269-271. Wealth figures are estimates for value of physical assets computed from data in R. R. Doane, Anatomy of American Wealth, New York, 1940, p. 223. The value for the median of each group has been used.
[2] Doane, op. cit., p. 223.
[3] Equalized value of taxable property. From Annual Report of the Massachusetts Commissioner of Corporations and Taxation, 1935, Boston, 1937. Per capita values have been computed.
[4] Computed from data in Illinois Tax Commission, Survey of Local Finance in Illinois, vols. 3 and 8, 1938 and 1940. Assessed values have been adjusted by the average assessment ratio, for the county in the case of the low-value town, since the town ratio was not available. A sample has been used and consequently the extremes may be even greater.
[5] New York State Commission for the Revision of the Tax Laws, Monograph No. 10. Albany, 1932, p. 89. The figures are for full value of land and improvements. The towns are a sample of 212 out of the total 932, and consequently the extreme variations may be even greater than these.
[6] S. E. Leland, ed., State-Local Fiscal Relations in Illinois, Chicago, 1941, p. 102. Figures are assessed values of taxable property per elementary-school child.

TABLE 6.—*Variations in per capita income and per capita income-tax collections in selected taxing jurisdictions in the United States, 1939*

Jurisdiction	High value	Low value	Ratio of high to low
	Per capita income		
6 regions[1]	$680	$296	2.3 to 1.
48 States[2]	848	$203	4.2 to 1.
	Per capita income tax liability		
77 Oklahoma counties[3]	$3.34	1 cent	334.0 to 1.
115 Oklahoma local divisions[4]	4.66	2 mills	2,330.0 to 1.

[1] Survey of Current Business, October 1940. The regions are those described in H. W. Odum, Southern Regions of the United States, Chapel Hill, 1936, pp. 269-271. The value for the median of each group has been used.
[2] Survey of Current Business, October 1940.
[3] Oklahoma Tax Commission, Income Taxes in Oklahoma, Bulletin No. 40, Oklahoma City, 1941.
[4] Source same as footnote 3. Local divisions are cities and rural areas of counties.

Income data below the State level, and wealth data at any level, are fragmentary and unreliable. Taxable wealth and income do not account for all wealth and income, and the proportions of wealth and income that are taxable will vary with the tax system and the nature and distribution of local economic resources. Evasion is an important and a variable factor. Neither assessed values nor equalized values are dependable. In view of these uncertainties, comparisons between the local units of different States have not been attempted; but the sources of error within a single State are fewer, and the variations shown are of such magnitude that errors of 100 percent in the figures for specific localities would not materially alter the conclusion.

Figures for income [6] and wealth, for taxable income and income tax collections, for assessed values and equalized values, all tell the same story. As the size of the local unit decreases, the variation in per capita wealth and income increases. All the comparisons of per capita wealth in local areas show much greater variations than appear between State values. The smallest local variations are in Massachusetts, which has a larger population in proportion to the number of its local units than any other State and which has a population per town, excluding cities, that is more than twice that of either Illinois or New York. Further, the variation for Illinois townships is far less than the variation for the smaller Illinois school districts.

The income figures likewise show more variations for the local divisions than for the States. When the rural and urban areas of a county are segregated, in the one State (Oklahoma) for which such a break-down has been found, the variation from one area to another is markedly greater than when the counties are taken as a whole.

The per capita income for individual States is given in table 7. This table also shows the ranking of the States for a composite measure of wealth,[7] and the changes in rank that have taken place between 1930 and 1940. The relative changes in regional income that have taken place in the past decade can be seen in table 8.

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[6] Available data are in terms of "income payments" rather than "income produced." The latter measure would largely eliminate the factor of absenteeism and would show less inequalities.

[7] The ranking for wealth has been obtained by ranking the States for each of the 20 series listed below separately. The highest value has been assumed to indicate the greatest wealth except in the case of series 5, 13, 14, and 18. For these four, the State with the lowest value has been placed first. The 20 ranks thus obtained for each State were then averaged to obtain a composite ranking. It has not been possible to obtain all the series for 1930 and 1940, but the only ones for which there is a marked difference—the education figures—are series that are not very sensitive to changes.

The 20 series are—

(1) Percentage increase in population, 1930 to 1940, and 1920 to 1930.
(2) Per capita cash farm income of farm population, 1940 and 1930.
(3) Value of land, buildings, machinery, and implements per farm, 1940 and 1930.
(4) Average size of farms, 1940 and 1930.
(5) Proportion of tenancy on farms, 1940 and 1930.
(6) Average wage in manufacture, 1939 and 1929.
(7) Per capita value added by manufacture, 1939 and 1929.
(8) Increase in value added by manufacture, 1929 to 1939, and 1919 to 1929.
(9) Electrical energy production per capita, 1939 and 1929.
(10) Value of mineral production per capita, 1938 and 1928.
(11) Per capita value of wholesale trade, 1939 and 1929.
(12) Per capita value of retail trade, 1939 and 1929.
(13) Persons per passenger car, 1939 and 1929.
(14) Infant death rate, 1938 and 1928.
(15) Annual public school cost per child, 1935-36 and 1925-26.
(16) Percentage of children aged 5 to 17 enrolled in public schools, 1935-36 and 1925-26.
(17) Per capita assets of Federal Reserve member banks, June 30, 1940, and June 30, 1930.
(18) Percentage of labor force unemployed, 1940 and 1930.
(19) Individual income tax per capita, 1940 and 1930.
(20) Net income per capita, 1929 and 1939.

All these series are indirect and imperfect measures of wealth, and selection of the specific series has been guided partly by the availability of the data. All are widely recognized, however, as being definitely related to wealth. The first, increase in population, would, in and of itself, decrease per capita wealth; but if population has increased because of migration to the places where employment opportunities are greatest, such increases become indicators of high per capita wealth in the absence of actual wealth figures. Some of the series will not respond quickly to changes in wealth, and consequently this measure will change less from year to year than the per capita income series. All the data are from Census figures except the following: (2) Crops and Markets, February 1941, p. 38; September 1931, p. 401; (9) Statistical Abstract; (10) Minerals Year Book, 1940 and 1930; (13) Automobile Manufacturers Association, Automobile Facts and Figures; (15) and (16) United States Bureau of Education, Biennial Survey; (17) Comptroller of the Currency, Annual Report; (20) Survey of Current Business, August 1941.

TABLE 7.—*Ranking of States according to per capita net income payments and wealth, 1930 and 1940*

State	Per capita net income			Rank for wealth	
	Income, 1940	Rank			
		1940	1930	1940	1930
Nevada	$960	1	7	2	4
Connecticut	864	2	4	4	10
New Jersey	852	3	2	8	7
Delaware	836	4	5	18	26
California	819	5	3	1	1
New York	814	6	1	6	3
Massachusetts	757	7	8	17	13
Rhode Island	730	8	9	20	27
Maryland	703	9	13	14	25
Illinois	691	10	6	7	9
Michigan	656	11	10	11	6
Ohio	644	12	12	16	11
Wyoming	638	13	14	9	8
Washington	633	14	15	5	2
Pennsylvania	624	15	11	25	19
Oregon	586	16	16	3	5
Montana	579	17	19	12	12
New Hampshire	560	18	18	28	34
Indiana	551	19	22	13	23
Colorado	551	20	23	15	22
Vermont	542	21	21	26	28
Wisconsin	537	22	17	23	15
Minnesota	526	23	25	10	17
Maine	504	24	26	33	33
Missouri	499	25	20	32	31
Utah	487	26	27	24	20
Arizona	478	27	24	21	14
Iowa	471	28	29	19	18
Idaho	470	29	30	22	21
Florida	465	30	31	29	35
Virginia	455	31	38	34	39
Nebraska	444	32	28	30	24
Texas	422	33	34	31	29
Kansas	418	34	32	27	16
West Virginia	401	35	33	36	37
North Dakota	385	36	37	41	36
South Dakota	384	37	36	35	30
New Mexico	356	38	41	38	38
Oklahoma	354	39	35	37	32
Louisiana	350	40	39	42	42
North Carolina	335	41	45	40	41
Kentucky	330	42	40	43	43
Tennessee	325	43	42	39	40
Georgia	321	44	43	44	45
South Carolina	281	45	48	46	47
Alabama	264	46	44	45	46
Arkansas	253	47	46	47	44
Mississippi	195	48	47	48	48

Source: Net income figures from Survey of Current Business, August 1941. Wealth index described on p. 191, n. 7 of this study.

TABLE 8.—*Ratio of 1940 to 1930 per capita income payments for States*

State	Per capita income		Ratio of 1940 per capita income to 1930 per capita income
	1930	1940	
			Percent
North Carolina	$263	$335	127.38
South Carolina	223	281	126.01
Virginia	383	455	118.80
Georgia	275	321	116.73
Nevada	828	960	115.94
Arkansas	222	253	113.96
Tennessee	295	325	110.17
New Mexico	325	356	109.54
Alabama	242	264	109.09
Montana	533	579	108.63
Texas	389	422	108.48

TABLE 8.—*Ratio of 1940 to 1930 per capita income payments for States*—Continued

State	Per capita income		Ratio of 1940 per capita income to 1930 per capita income
	1930	1940	
			Percent
Indiana	$510	$551	108.04
Delaware	778	836	107.46
North Dakota	361	385	106.65
Kentucky	317	330	104.10
Michigan	631	656	103.96
Oregon	568	586	103.17
Maryland	683	703	102.93
Florida	455	465	102.20
Connecticut	850	864	101.65
Vermont	545	542	99.45
Ohio	649	644	99.23
Oklahoma	357	354	99.16
Washington	642	633	98.60
Louisiana	355	350	98.59
Wyoming	649	638	98.30
Idaho	479	470	98.12
West Virginia	409	401	98.04
Minnesota	537	526	97.95
Utah	506	487	96.24
Mississippi	204	195	95.59
Arizona	502	478	95.22
Rhode Island	770	730	94.80
Colorado	582	551	94.67
Wisconsin	570	537	94.21
California	877	819	93.39
New Jersey	913	852	93.32
New Hampshire	605	560	92.56
Massachusetts	825	757	91.76
South Dakota	420	384	91.43
Illinois	762	691	90.68
Maine	556	504	90.65
Missouri	552	499	90.40
Iowa	522	471	90.23
Pennsylvania	693	624	90.04
Kansas	476	418	87.82
Nebraska	542	444	81.92
New York	1,012	814	80.43

Source: Survey of Current Business, August 1941.

Notable changes in the relative position of individual States have taken place in a single decade. When ranked according to wealth, Maryland has risen 11 places, from twenty-fifth to fourteenth; and Kansas has fallen 11 places, from sixteenth to twenty-seventh. When ranked according to income, Virginia has risen 7 places, from thirty-eighth to thirty-first, and Missouri has fallen 5 places, from twentieth to twenty-fifth. We have become accustomed to great changes in income from year to year for the country as a whole; but the wide variations between regions are often concealed in national averages. If such changes as these can take place in the relative position of individual States in a single decade, it is apparent that the advantages that make one region richer than another in any particular year are not necessarily continuing advantages. The State with the highest per capita income in 1930 is not the State with the highest per capita income in 1940. At the other end of the scale there is less change. The factors which made the South (and particularly Mississippi) poor in 1929 are keeping it poor today. Even here, however, there are signs of change. Florida has pulled itself out of the lowest group in the past 25 years. Virginia and North Carolina are definitely improving their positions. It is quite possible that other Southern States will follow.

(*b*) *Immobilities as a source of inequality.*

Such variations in wealth and income as appear in these data are an indication of the degree to which pure and perfect competition are lacking. Unequal access to natural resources is in part responsible for unequal per capita wealth and income.[8] Some areas have better farm land than others, or richer mineral resources, more valuable forests, better harbors and natural waterways. Some have greater accessibility to markets—for relatively poor farm land near a large city may be more valuable than better land remote from the market; and rich copper ore in a mountainous region far from railroads and highways may be worthless. Different methods of production are also a cause of inequality. The community with the best equipment will have an important advantage over other communities.

With perfect competition, the population would be so distributed in relation to resources that the rich regions would have correspondingly more people to support; industries would find the most favorable location between sources of raw materials and final markets; the methods of production would be those best adapted to local circumstances; and the per capita wealth and income would be much the same in all areas. Perfect competition is not, of course, attainable. Perfect knowledge on the part of buyers and sellers, and perfect freedom of movement of buyers and sellers and commodities, are conditions that might conceivably be approached; but there can never be a perfectly elastic supply of all the factors of production. New York, e. g., has superior harbor facilities, with only a limited area of land giving access to them. The owners of this land are in a position to exact high rents. This will increase the per capita income of the area without attracting people from lower-per-capita-income areas, since the new arrivals would not be in a position to participate in the higher average income of the area.

There is, in fact, substantial migration of population from the poorer to the richer areas, but there is always a lag. Information concerning occupational openings is not readily available. Even if it is known that good positions are open in another community, there is no assurance that the openings will continue long enough to justify a move; no certainty, even, that they will not be filled before application can be made. Also, the individuals in greatest need are not apt to have enough resources to move themselves and their families. They do not always have the skills that offer the best remuneration. They do not always like to leave familiar places and accustomed occupations.

Management, as well as labor, seeks the most favorable opportunity, but it suffers from much the same handicaps, although in different degree. Management is apt to be better informed than labor; and less influenced, perhaps, by personal considerations. It may have more resources at its command. But, by the same token, it usually has larger investments in fixed capital to hold it where it is; and it suffers from the same uncertainties as to the duration of the new opportunity.

Thus there is a lag in the migration of capital. Fixed capital is, as its name implies, relatively immobile. It is comparatively durable. When the cotton textile industry moved south, the mills, most of

[8] See, however, discussion under the section on mineral resources and agriculture below.

the machinery and laborers, and a large part of the management remained in New England. Most of the southern industry is essentially new.

Methods of production change slowly. Differences in economic status may result from the different requirements of the fundamental resources. They may result, also, from lack of information, untrained workers, obsolete equipment, or the prohibitions imposed by patents.

These lags have been accentuated, in recent years, by rapid change. Technological changes have been revolutionary in the twentieth century. Machines are sometimes obsolete before they are installed; and skills may be superseded almost before they are learned. At the same time, there is some evidence that more fixed capital, on the one hand, and greater skill on the other, are being required. This fosters monopoly, and monopoly hinders adjustment. The investigations of the Temporary National Economic Committee have called attention to the fact that the larger part of many of our leading manufactured products, and some of our raw materials, is the output of such a small number of companies that agreements to limit competition are easy to reach, and correspondingly frequent. Government policies, too, have interfered with competitive forces. Trade barriers have increased, and wars have completely distorted the competitive pattern of industry.

It does not follow that geographic inequalities of wealth and income are increasing; for improvements in the means of communication and transportation have served as a counteracting force—facilitating the movement of population and materials, and the exchange of ideas and information. In fact, it is quite possible that this has more than offset the factors listed above that are fostering inequalities, especially within the boundaries of this country.[9]

The fact remains, however, that the geographic inequalities of wealth and income in the United States today are very great, and Government fiscal policies must be shaped in the light of these variations.

4. INDUSTRIAL AND OCCUPATIONAL FACTORS IN THE GEOGRAPHICAL DISTRIBUTION OF WEALTH AND INCOME

It is a matter of general knowledge that wealth and income tend to accumulate in urban centers. Analysis of the distribution of wealth makes it clear that rich natural resources do not usually produce great wealth for the communities primarily engaged in developing them; only when the presence of great natural resources attracts large cities is the wealth created by the development of these resources localized in the vicinity of the resources themselves. Forestry requires and supports only a very sparse population. Agriculture requires a somewhat denser population than forestry, but it is necessarily rural; and the trade created by the farming population demands only small trading centers. Mining requires towns, rather than cities, and the towns are normally very poor. Only rarely has a large city developed in a mining region because the mines were there. Pittsburgh is the outstanding exception; and there have been other factors favoring the growth of Pittsburgh.

[9] An analysis of the decennial census figures for per capita wealth of States shows only slight changes in the average deviation from decade to decade, and no definite trend in either direction.

Manufacturing requires and supports a relatively dense population at a higher standard of living than is found in most rural areas. But in large metropolitan regions, where cities are specialized, it is not usually the manufacturing city that has the greatest per capita wealth. If the manufacturing wage earners live in a separate jurisdiction from that in which they work, and from that in which their employers live, the local income level where the workers live will not differ greatly from that of the rural areas. Even when the plant is in the same jurisdiction as the homes of the workers, taxable wealth will not usually measure up to that in the communities where commerce and finance are the principal activities. The only regions that can compare with these latter communities are a few restricted residential areas in which those engaged in commerce and finance reside.

(*a*) *Relation to raw materials.*

Per capita income tends to be in inverse proportion to the farm population. The per capita income for the entire population was $573 in 1940, as compared with $277 per capita farm cash income for farm families in that year. These 2 figures are not, of course, strictly comparable, but the median per capita income of the 12 States with the smallest proportion of the population on farms was more than double that of the 12 States with the largest proportion of the population on farms—$744 as compared with $328. The data for the 6 States at either extreme are given in table 9.

TABLE 9.—*Comparison of proportion of rural farm population with per capita income payments for States having the smallest and the largest proportion of population on farms, 1940*

States with smallest proportion of population on farms			States with largest proportion of population on farms		
State	Proportion of rural farm population, percent	Per capita income	State	Proportion of rural farm population, percent	Per capita income
Rhode Island	1.3	$730	Mississippi	61.2	$195
Massachusetts	2.1	757	Arkansas	57.1	253
New Jersey	3.3	852	North Dakota	51.1	385
New York	5.1	814	South Carolina	48.1	281
Connecticut	5.6	864	South Dakota	47.7	384
Pennsylvania	9.1	624	Alabama	47.3	264

Source: Census of Population: 1940; Survey of Current Business, August 1941, p. 11.

The county of Saline, Ark., is a particularly interesting instance of the fact that possession of important natural resources does not insure local enjoyment of any unusual income. One-fifth to one-fourth of the aluminum produced in the United States by the Aluminum Co. of America apparently comes from domestic ore mined in Saline County. At least the only domestic bauxite used for aluminum comes from this area, and the Republic Mining & Manufacturing Co., a completely owned subsidiary of the Aluminum Co. of

America, has extensive mining properties at Bauxite in this county. Approximately three-fourths of the Aluminum Co.'s bauxite comes from Surinam (Dutch Guiana).[10]

About one-fifth of Saline's workers are employed in bauxite mining (1929). Yet this practical monopoly of an important natural resource has brought no great wealth to the county. Per capita retail sales in 1939 were only about two-thirds of the State average, and about one-third of the National average. They were lower than those of any of the other counties included in this comparison. The proportion of the population making Federal income-tax returns was one-eighth of the national average. State personal income tax collections amounted to 10 cents per capita and State corporation income-tax collections amounted to 1 cent per capita in 1938. The State averages this year were 16 cents and 17 cents, respectively. The State has a severance tax on bauxite, but this produced only one-tenth of 1 percent of the State's tax revenues in 1938.[11]

If the ore is followed to Alcoa, Tenn.,[12] where a large hydroelectric plant supplies the power for manufacturing aluminum, there is still little evidence of local benefits. In spite of the fact that this is one of the few relatively accessible regions that can supply electric power cheaply enough, the county of Blount, in which the plant is located, has per capita retail sales of only $154 and 23 income-tax returns per 1,000 population—both less than half of the national average.

Yet the Aluminum Co. of America, with its head office in Pittsburgh, earned an average of 12 percent on its investment in the years 1935–39,[13] and its net income of $44,000,000 in 1940 was an all-time high. This company has other plants and other interests, but the Alcoa plant is one of the most important, producing about 40 percent of the total aluminum output in 1940, and the Saline County mines probably are supplying at least one-fifth of the company's raw materials. It is interesting to note that if even 1 percent of the net income of the Aluminum Co. of America, as reported in Pittsburgh for 1940, had gone instead to the residents of Saline County the per capita income would have been raised about $25. It would apparently take about 3 percent of the Aluminum Co.'s income to bring the county average up to the average for the State, and about 15 percent to bring it up to the United States average.

These comparisons are made to show that the income earned by the aluminum industry was great enough to have made it possible for some of the communities at the source of raw materials and power to have received at least average income. It does not necessarily

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[10] Moody's Manual of Investments, 1939, and Minerals Year Book, 1940.

[11] Biennial Report of the Arkansas State Comptroller, 1936-37 to 1938–39.

[12] Actually, the ore goes first to East St. Louis, where it is reduced to aluminum oxide. East St. Louis is a large city with other important manufacturing plants so that it is impossible to trace the effect of this one plant. It is, however, relatively poor for a manufacturing city of its size.

[13] Temporary National Economic Committee, Investigation of Concentration of Economic Power, Monograph No. 21, Competition and Monopoly in American Industry, 1940, p. 72.

follow that they would have received better incomes under competitive conditions. The wages in the southern plants of this company, at the time of the strike in April 1941, were reported as being 51 cents an hour as compared with 65 cents in the northern plants.[14] But it is quite possible that the workers' earnings are equal to anything they could command in other occupations in this region. And it is possible that, in competition with workers in Surinam, a higher wage would close the Arkansas mines. Without little if any domestic competition for the product, however, the wages paid to the Aluminum Co.'s workers are an inadequate test of marginal productivity, and a substantial redistribution of the income of the Aluminum Co. would still leave more than average profits.

The failure of the communities endowed with these exceptional natural resources—commercially valuable bauxite ore and exceptionally cheap hydroelectric power—to derive any unusual income from their unusual natural advantages is not exceptional, but quite typical. Fayette County, Pa., the home of more than one-third of the laborers in the steel companies' captive mines,[15] is poor, even for a Pennsylvania coal-mining region. The West Virginia, Kentucky, and Illinois coal-mining areas are even poorer. The Texas cotton farms and oil fields are found in some of the poorest sections of that State. This is true also of the Minnesota iron-ore beds and the North Carolina tobacco farms.

No one questions that all these raw materials have contributed greatly to our national well-being. Yet the specific areas where these natural resources are being developed are not the richest sections of the country. The per capita income of the States is roughly in inverse proportion to their dependence on agriculture, and only one-third of the States with the highest per capita mineral production are in the upper half of the States ranked according to per capita income.

Table 10 shows that the production of important raw materials does not insure a high place in the income scale. Among the wealthy States, only California appears as an important producer of raw materials. Texas, with 36 percent of the domestic petroleum output and 24 percent of the domestic cotton production, ranks thirty-third in per capita income. The other important cotton States are the poorest in the United States. None of the important wheat-producing States has a per capita income as great as the national average. The tobacco States are ever poorer; and West Virginia, with more than one-fourth of the domestic output of coal, is thirty-fifth from the top in income. It is interesting to note that none of the three richest States is represented in the group of leading producers of raw materials, whereas each of the three poorest States is among the leading States for one of these raw materials.[16]

[14] New York Times, April 21, 1941, p. 10.
[15] 20,000 out of 53,000 miners (New York Times, November 13, 1941, p. 23). This is 10 percent of the county's population.
[16] For county data see the sections on agriculture and minerals.

TABLE 10.—*Per capita income payments for States leading in the production of specific raw materials*

Product	State	Rank for product	Per capita income payments [1]	Rank for income
Cotton [2]	Texas	1	$390	33
	Mississippi	2	194	48
	Arkansas	3	235	47
Wheat [2]	Kansas	1	398	31
	North Dakota	2	322	39
	Oklahoma	3	335	38
Tobacco [2]	North Carolina	1	291	41
	Kentucky	2	294	40
	Virginia	3	388	34
Lumber [2]	Oregon	1	522	17
	Washington	2	570	12
	California	3	729	4
Coal [3]	West Virginia	1	372	35
	Pennsylvania	2	541	15
	Illinois	3	599	10
Petroleum [3]	Texas	1	390	33
	California	2	729	4
	Oklahoma	3	335	38
Iron ore [3]	Minnesota	1	481	21
	Michigan	2	545	14
	Alabama	3	236	46

[1] Survey of Current Business, August 1941. Data are for 1938. The average for the United States in 1938 was $511.
[2] Department of Agriculture, Agricultural Statistics, 1940. Data are for 1939, with the exception of lumber, which is for 1938.
[3] Department of the Interior, Bureau of Mines, Mineral Yearbook, Review of 1940. Data are for 1939.

Turning to the wealthy States, Nevada's high per capita income can hardly be traced to unusual natural resources. Its sparse population bears witness, rather, to lack of natural advantages. A little copper, silver, and gold, and some large-scale farming, supplemented by a thriving divorce business, have brought comparative prosperity to its few inhabitants. Only California of the six States with the highest per capita income has unusual mineral, forest, and agricultural resources. The rest have obtained their income from the manufacture, trade, and finance that have been built on the natural resources of other States. Connecticut's munitions industries must use Minnesota iron ore, and Pennsylvania and West Virginia coal. New Jersey's petroleum refineries obtain their supplies in large part from Texas and Oklahoma oil. Delaware's chemical industries draw on a wide variety of raw materials from many States, and New York's financial center prospers or languishes with the industry of the entire Nation.

(*b*) *Manufacturing.*

Some relation between manufacturing and per capita income by States is found, but the correlation is not high. When cities are grouped according to the per capita value of manufactured products, it appears that those with the highest per capita values have a lower number of Federal income tax returns per thousand of the population than the cities with the lowest per capita value of manufactured products. In other words, the city in which manufacturing predominates tends to be poorer than the city which is primarily commercial or residential. This holds true of every size group as shown in table 11. This does not mean, of course, that manufacturing is not one of the more profitable business functions; but it does indicate that those who profit most from manufacturing tend to live in another community than the one in which the manufacturing plant is located.

TABLE 11.—*Federal income tax returns per 1,000 population in manufacturing and nonmanufacturing cities, 1939* [1]

Population group	Number of returns per 1,000 population	
	Cities with highest per capita value of manufactured product	Cities with lowest per capita value of manufactured product
1,000,000 and over	108	170
250,000 to 1,000,000	98	99
100,000 to 250,000	77	81
60,000 to 100,000	82	112
35,000 to 50,000	74	103
10,000 to 15,000	81	83

[1] For all but the first and last groups, the figures used for each population group are the medians for the 15 cities with the highest per capital value of manufactured product and the 15 cities with the lowest per capita value. For the last group, the medians of the 25 highest and 25 lowest cities are used. For the first group (which includes only 5 cities), the figure shown for the cities with the lowest per capita value of manufactured product is for Los Angeles, while the figure for the highest is for Detroit. The averages of the two highest and the two lowest cities in this population group, however, show the same general relationship between number of income tax returns filed and the value of manufactured products. Reclassification by satellite and independent cities, and changing the number of cases in the high and low value of manufactured product categories does not alter substantially the results obtained by the above method.

Sources: Bureau of Internal Revenue, Individual Income Tax Returns for 1939—Number of Returns by States, Counties, Cities, and Towns (mimeograph); Census of Manufactures, 1939.

(c) *Retail trade.*

Retail trade is essentially a local business. New York City enjoys a luxury trade that attracts shoppers from the whole United States, but this is an insignificant part of even New York City's retail trade. The big mail-order houses depend increasingly on local stores. Moreover, the entire mail-order business is only 1 percent of retail trade.[17]

Comparisons of subdivisions of the retail trade reveal that for food sales the satellite cities hold their own with the independent cities. This is shown in table 12. For clothing, however, the independent city has a clear advantage over the satellite city. Also, while size does not seem to affect the per capita clothing trade for the three groups of larger cities, there is a marked falling off in this trade in the smallest cities, both independent and satellite. Apparently, the city of 20,000 population can offer the necessary assortment and style, and the city of 5,000 population cannot.

TABLE 12.—*Per capita receipts from retail trade in selected cities, 1939* [1]

ALL RETAIL TRADE (UNITED STATES AVERAGE, $319)

Population group	Independent cities [2]		Satellite cities [2]	
	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$428		
75,000 to 175,000	11	506	11	$401
11,000 to 27,000	15	524	15	438
4,000 to 7,000	17	659	16	328

See footnotes at end of table.

[17] Bureau of the Census, Census of Business, 1939, "Retail Trade."

TABLE 12.—*Per capita receipts from retail trade in selected cities, 1939*—Continued

FOOD AND GENERAL STORES, INCLUDING FOOD (UNITED STATES AVERAGE, $83)

Population group	Independent cities		Satellite cities	
	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$92		
75,000 to 175,000	11	96	11	$116
11,000 to 27,000	14	120	15	118
4,000 to 7,000	17	126	16	110

APPAREL AND GENERAL MERCHANDISE GROUP (UNITED STATES AVERAGE, $68)

Population group	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$134		
75,000 to 175,000	11	137	11	$80
11,000 to 27,000	15	136	14	82
4,000 to 7,000	15	111	12	49

AUTOMOTIVE GROUP (UNITED STATES AVERAGE, $42)

Population group	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$37		
75,000 to 175,000	11	77	11	$49
11,000 to 27,000	15	102	14	100
4,000 to 7,000	14	105	12	95

EATING AND DRINKING PLACES (UNITED STATES AVERAGE, $27)

Population group	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$41		
75,000 to 175,000	11	37	11	$34
11,000 to 27,000	15	37	15	30
4,000 to 7,000	17	40	16	24

[1] The complete sample consists of 90 cities, but figures are not given for all these in some of the subgroups because of the small number of firms. Complete figures for all cities from the Census of Business, 1935, show that the per capita retail trade for satellite and independent cities combined remains almost constant for cities of different sizes down to places of 2,500 to 5,000 population. For apparel and general merchandise, however, per capita sales decline with the size of the city, except in the group from 2,500 to 5,000.

[2] The cities described as independent are in all cases located in counties in which there is no other larger city, and they are at least 50 miles from any substantially larger city. Satellite cities are in metropolitan areas, as defined by the Census.

Source: Bureau of the Census, Census of Business, 1939, "Retail Trade."

Sales of automobiles and automobile equipment increase markedly as the size of the city declines, although there is little difference between the 5,000 and the 20,000 group. The sales of eating and drinking places show little variation either for size of city or for independent and satellite cities.

When New York City is compared with individual independent cities, it appears that New York City's trade, relative to its population, is surpassed by that of the majority of other cities. Of the 48 independent cities, 37 had a higher per capita total. Even for clothing, 25 cities exceeded the New York average. All the cities in the group exceeded New York for automobile sales. Only for eating and drinking places did New York more than hold its own, being surpassed by only 6 cities in the group. A comparison of trade in New York and in the leading city of each size group is given in table 13.

TABLE 13.—*Comparison of per capita retail trade of New York City and the city with the highest total per capita trade in each population size group* [1]

City [2]	Total retail trade	Food and general stores	Apparel and general merchandise	Automotive stores	Eating and drinking places
New York, N. Y.	$428	$116	$117	$22	$62
Peoria, Ill.	582	122	175	90	43
Salinas, Calif.	1,231	222	182	266	82
Newport, Vt.[3]	751	144	178	174	22

[1] Size groups shown in table 12 (pp. 200-1).
[2] The population of Peoria is 105,087; Salinas, 11,586; Newport, 4,902.
[3] The maximum for cities of this size is $827, but the break-down for all the subgroups is not available for the city with the largest per capita retail trade.

Source: Bureau of the Census, Census of Business, 1939, "Retail Trade."

(*d*) *Wholesale trade.*

Wholesale trade profits in much the same way as financial enterprises from concentration in large cities. Insofar as the commodities dealt in are standard, and can be ordered from specifications or sample, high rents and congested traffic are minor considerations, and easy communication with others in the trade is of first importance. Insofar, however, as this activity involves storage, deals with products that are not readily standardized, and supplies local markets from local sources, it will be decentralized.

Wholesale trade is not concentrated in one section of the country to the extent that manufacturing and financial activities are. Neither is it spread as evenly over the entire country as is retail trade. The range between the highest and lowest States is double that for the retail trade. The States with the largest per capita wholesale trade are widely scattered. The wholesale market for some products is national; but to a large degree each region is served by its own wholesale center. The wholesale trade is a function of large cities, but the cities in which it is concentrated are widely distributed over the entire country.

New York City had nearly one-fourth of the total wholesale business in 1939. If the trade of Chicago and Boston is added to that of New York, more than one-third of the business is accounted for. And more than half took place, in 1939, in the 11 cities with more than 600,000 population. The value of sales in these cities varied from $674 to $2,169 per capita, as compared with $417 per capita for the United States as a whole.

There are substantial variations among cities that are not to be explained on the basis of size. San Francisco, the smallest city in this group of 11, has a wholesale business that is exceeded only by New York, Chicago, Boston, and Philadelphia. Also, when a number of large cities are close together, the wholesale trade tends to concentrate in the largest, leaving the others with relatively little of the trade as compared with more isolated cities with the same population. Satellite cities have only about one-third as much wholesale business as independent cities of the same size. This is shown in table 14.

TABLE 14.—*Per capita receipts from wholesale trade, in selected cities, 1939* [1]

Population group	Independent cities		Satellite cities	
	Number	Median per capita sales	Number	Median per capita sales
1,000,000 and over	5	$854		
75,000 to 175,000	11	793	11	$224
11,000 to 27,000	15	409	12	148
4,000 to 7,000	13	288	[2] 7	100

[1] The cities are the same as those in table 12 (pp. 200-1).
[2] For 6 more cities, which were included in the sample, the Census Bureau did not publish sales data to avoid disclosure of information concerning individual firms. This indicates that the number of wholesale concerns in these 6 cities is very small, and suggests that the wholesale sales in these cities would be even smaller than in most of the cases for which data were published.

Source: Bureau of the Census, Census of Business, 1939, "Wholesale Trade."

(*e*) *Finance.*

The New York and Chicago data, shown in table 15, indicate that financial operations tend to be more concentrated than physical production. Financial operations are especially adapted to large cities. Ease of communication with all the important participants in the business is the principal requirement. And since only intangibles are dealt in, the congestion of traffic and high rents, which are a serious handicap to the business handling large quantities of physical commodities, offer no obstacles.

TABLE 15.—*Percentage of different types of business and nonbusiness activities concentrated in New York City and Chicago* [1]

Activities	New York City	Chicago	New York and Chicago
	Percent	*Percent*	*Percent*
Percentage of United States population, 1940	5.7	2.6	8.3
BUSINESS			
Value of stocks and bonds sold on organized markets, 1939 [2]	95.1	1.1	96.2
Admitted assets of life insurance companies, 1937 [3]	42.9	.6	43.5
Head offices of large corporations [4]	40.4	11.6	52.0
Assets of member banks, 1940 [5]	29.6	6.5	36.1
Wholesale trade, gross receipts, 1939	23.4	7.4	30.8
Federal corporation-income-tax collections, 1940 [6]	22.0	8.0	30.0
Federal personal-income-tax collections, 1940 [6]	21.5	7.8	29.3
Service industries, gross receipts, 1939	15.2	6.2	21.4
Hotels, gross receipts, 1935 [7]	13.9	6.1	20.0
Retail trade, gross receipts, 1939	7.5	3.6	11.1
Manufacturing, value of products, 1939 [8]	7.2	5.0	12.2
Newspaper and periodical publishing and printing, 1937 [9]	21.8	7.5	29.3
NONBUSINESS			
Head offices of national organizations, 1940 [10]	48.6	7.8	56.4
Students in institutions of higher learning, 1934-36 [11]	10.8	3.3	14.1

[1] Figures are from Census of Population: 1940, and Census of Business: 1939, unless otherwise designated.
[2] Securities and Exchange Commission, Annual Report, 1939.
[3] Temporary National Economic Committee, Investigation of Concentration of Economic Power, hearings, pt. 4, 1939, and Moody's Manual of Investments, Banks and Insurance Companies, 1939.
[4] 250 largest corporations as tabulated by National Resources Committee, The Structure of the American Economy, pt. I. Of these 50 are financial and the remaining 200 are industrial, railroad, and public utility firms.
[5] June 30, 1940. Federal Reserve Bulletin. Brooklyn banks are not included.
[6] First, second, third New York districts and first Illinois district. Annual Report of the Commissioner of Internal Revenue, 1940.
[7] Census of Business: 1935, "Hotels."
[8] If the New York and Chicago industrial areas, as defined in the Census of Manufactures, are substituted for the cities, the New York area had 12.2 percent of manufactures in 1939 (as compared with 8.2 percent of the population), and the Chicago area had 7.5 percent of manufactures in 1939 (as compared with 3.7 percent of the population).
[9] 47.7 percent of the 369 trade magazines listed in Standard Rate and Data Service in 1940 had publication offices in New York City (L. A. Drake, Trends in the New York Printing Industry, New York, 1940, p. 27).
[10] 722 educational, philanthropic, religious, labor, trade, and other organizations, with a national membership, reported in the World Almanac, 1941.
[11] United States Office of Education, Biennial Survey of Education, 1934-36.

These financial transactions involve all industries. They provide the capital for factories operating in every State; they finance the storage, processing, and marketing of agricultural products; and they provide the means for producing and transporting petroleum and other minerals. The capital is accumulated from investors residing in every State. There are single corporations with shareholders in practically every city. This is a business that concerns the entire nation, and the fact that it tends to concentrate in a limited geographic area does not endow it with the characteristics of local enterprise.

The capital market is primarily in New York City. As has been noted, this city has a practical monopoly of the business of selling securities. Also, it is the home of the largest banks, and the location most frequently chosen for head offices by the corporations doing a nation-wide business. The interrelations among the big industrial and public-utility corporations, the commercial and investment bankers, and the corporation lawyers, still require frequent personal conference, in spite of the telephone and other facilities for communication. Consequently, these activities tend to concentrate, not merely in New York City, but in the Wall Street district.

Commercial banking is more widely scattered than the business of marketing securities. As long as nation-wide branch banking is forbidden, and there are 12 Federal Reserve banks instead of 1, this will continue to be true. Also, the ordinary commercial loan is smaller and more temporary than the usual securities flotation, and there is a personal and local element in commercial banking that is, perhaps, lacking in the securities business. Even so, the two central reserve cities account for more than one-third of the assets of Federal Reserve member banks, and half of such assets are in three States—New York, Illinois, and Pennsylvania.[18]

When the States are ranged in order of per capita member-bank assets, it is found that 10 of the 12 States in the top quartile form a solid block ranging from New Hampshire to Maryland. Illinois and California are the only States in the top quartile outside of this Northeastern region.

In addition to this regional concentration of banking assets there is, of course, a marked concentration in the larger cities. The central reserve and reserve cities combined have 72 percent of the total member-bank assets, although these cities account for only 24 percent of the population. Even the "country" banks that have the remaining 28 percent of the assets are located in urban areas. A small bank, serving a limited local area, is a poor risk, as American banking history has amply demonstrated.

The large insurance companies have not settled in New York City to the extent that other large corporations have, largely in consequence of their very early development in other cities.[19] However, all but 4 of the 17 largest companies are located within the area bounded by Boston to the east and Philadelphia to the west, and more than half of the assets of these 17 companies belong to the New York City group. This is shown in table 16.

[18] Much the same concentration is found when nonmember banks are included. Approximately half of the nation's banking resources are concentrated in these three States.

[19] All the 17 largest companies were incorporated between 1841 and 1873.

TABLE 16.—*Geographic distribution of large life insurance companies, 1940* [1]

City	Number of companies	Percentage of total assets
New York City	4	51.2
Hartford	3	8.7
Boston	2	6.0
Newark	2	20.4
Philadelphia	2	4.3
Springfield	1	2.9
Total Northeast region	14	93.5
Other regions	3	6.5
Total	17	100.0

[1] These companies had 79.5 percent of the total admitted assets of life insurance companies.

Source: Temporary National Economic Committee, Investigation of Concentration of Economic Power, Hearings, pt. 4, Life Insurance, 1939, pp. 1514-1515.

The business of granting corporation charters would normally follow head offices and financing operations. Here, however, State laws have warped the "natural" pattern. The direct bid from Delaware, and, to a lesser extent, from other "incorporating" States, has been successful, since these States have not required the physical presence of the officials carrying on the business. Thus 27 percent of the largest corporations in 1937 had obtained their charters from Delaware, although only 7 percent of this group maintained their principal offices there. New York State's share of the charters, on the contrary, was 17 percent, as compared with 40 percent of the head offices. More detailed data are given in table 17.

TABLE 17.—*Geographic distribution of States of incorporation and States of principal office for the 164 largest corporations, 1937* [1]

State	Number obtaining charters in State	Number maintaining head office in State
Delaware	45	12
New York	28	65
New Jersey	24	6
Pennsylvania	13	16
Illinois	9	19
Ohio	10	11
All other States	35	35
Total	164	164

[1] Corporations with assets of $100,000,000 and over.

Source: Securities and Exchange Commission, Statistics of American Listed Corporations, Part 1, Summary Report, 1940, pp. 150-151.

5. VARIATIONS AMONG POLITICAL UNITS IN METROPOLITAN AREAS

Some of the variations in economic conditions among different political units in a single metropolitan area may be discerned by an analysis of data showing income-tax returns per 10,000 persons, percentage of wage earners in manufacture, and per capita retail sales for the metropolitan districts of Boston and New York. For Boston, figures for per capita equalized value of taxable property and for tax rates are also analyzed.

In these metropolitan areas, the percentage of wage earners in manufactures is relatively low in the central city. This is to be expected from the tendency of manufacturing to gravitate toward the edges of large cities. The proportion of income-tax returns is also relatively low in the central city. This suggests that returns are more commonly made at the place of residence than at the place of business. The extremes for both measures are found in the outlying areas, and in general those communities with the highest proportion of wage earners have the lowest proportion of income-tax returns. The manufacturing cities and the residence cities are thus clearly distinguished.[20]

The per capita retail trade of the central city for the different metropolitan districts varies widely. The highest retail sales in the New York City area are in the outer fringes of the region. For the Boston area they are in the city itself. There is some tendency for retail sales to be highest in the cities with the highest proportion of income-tax returns, but the relationship is not close.

For the Boston district, where taxable values are also available, further comparisons can be made. The city of Peabody, with the largest proportion of wage earners, has a low taxable value per capita and one of the highest tax rates in the area. Brookline, with the largest proportion of income-tax returns, has one of the highest taxable values per capita and the second lowest tax in the area. It is the wealthy taxpayers' oasis of this metropolitan district.

A comparison of the distribution of manufactures, taxable incomes, and retail sales in different metropolitan areas shows that there is no regularity in the metropolitan pattern. At the same time, there is substantial division of economic function and wide variation in taxable wealth from one small taxing authority to the next.

In the New York metropolitan area Kearny and Harrison, N. J., are manufacturing cities. Manufacturing wage earners comprise 29 percent of the Kearny population and 68 percent of the Harrison population.[21] And the residents are relatively poor for this area. The proportion of income-tax returns is only 41 per thousand of the population in Kearny and 63 in Harrison.

White Plains, on the contrary, is a well-to-do residential city. Manufacturing wage earners constitute only 2 percent of the population and income-tax returns per thousand are 275. The United States Steel Corporation and Western Electric Co. have their head offices in New York City and some of their plants in Kearny. Some of the more important Harrison plants belong to the Otis Elevator Co., the Worthington Pump & Machinery Co., and Radio Corporation of America — also with offices in New York City. It is quite probable that some of the salaried officers of these corporations commute from White Plains to the down-town New York offices. It is also quite probable that many of the Kearny and Harrison wage earners live in Newark and other nearby places. In other words, a closely knit economy has been split up into arbitrary political units. Kearny

[20] These generalizations apply equally to all the other metropolitan areas analyzed: Chicago, Detroit, Los Angeles, and Pittsburgh.

[21] This is an overstatement insofar as the wage earners live in other communities, but it makes it clear that manufacturing is the principal business of these cities.

and Harrison can tax the shipbuilding and other plants in order to provide for police and fire protection; but Newark will not be able to tax these plants to provide relief money when the wage earners lose their jobs. White Plains can tax its home owners for the education of their children, but New York City cannot tax them to cover the cost of maintaining the highways over which they drive twice daily.

The city of Los Angeles completely surrounds the city of Beverly Hills. The residents of the two cities pass back and forth as freely as if the area were the single city that it appears to be. But Beverly Hills offers a tax oasis to its comparatively wealthy residents, and Los Angeles cannot tax it.[22] The city of Hamtramck, containing the Chrysler plant, is a small industrial enclave in the midst of the city of Detroit. Many of its employees doubtless live in the latter city and their children probably attend the Detroit schools; but the city of Detroit cannot tax Hamtramck's relatively high property values, and Hamtramck's tax rate is only about three-fourths of Detroit's tax rate.[23]

6. DISTRIBUTION OF FEDERAL TAX COLLECTIONS, BY STATES, IN RELATION TO FINAL TAX INCIDENCE

Federal tax collections are very unequally distributed among the States. Using per capita figures as the test of inequality, one finds that in 1940 the per capita personal income tax, corporation income tax, and estate and gift taxes collected in Delaware were 172, 275, and 188 times, respectively, those collected in North Dakota.[24] Delaware led, also, in the collection of employment taxes per capita, although the variation was not as great for this tax, being 20 times Mississippi collections.

Customs duties and stock-transfer taxes are very highly concentrated in New York, and tobacco-tax collections are made mainly in North Carolina, Virginia, Kentucky, and New Jersey, with no collections of these taxes in a number of States. Kentucky leads in the collection of liquor taxes, with 807 times Mississippi per capita collections in 1940; and Michigan leads in collections of manufacturers' excises with 227 times South Carolina per capita collections in 1940. Per capita collections for several important taxes, for each State for 1940, are given in table 18 (pp. 210–12).

The distribution of all 1940 tax collections is given in table 19 (pp. 213–18), together with the estimated incidence of these taxes. The specific assumptions concerning the incidence of the various taxes are given in the footnotes of this table. Further comments concerning the validity and limitation of the various assumptions are submitted in the following footnote.[25]

[22] The equalized value of taxable property per capita in Beverly Hills is more than 2½ times the value in Los Angeles, and the tax rate on this equalized value is less than 60 percent of the Los Angeles rate. California State Board of Equalization, Biennial Report, 1939–40, and California State Controller, Annual Report of Financial Transactions of Municipalities, 1940.

[23] Per capita full values of taxable property were $1,830 in Hamtramck and $1,486 in Detroit in 1940, and the Hamtramck tax rate was only about three-fourths of the Detroit rate. Municipal Year Book, 1941.

[24] The corporation tax figures are allotted statistically to the State of home office or other place of reporting.

[25] It is generally assumed that the personal income tax cannot be shifted. The arguments for this are too well known to be repeated here. However, collections do not necessarily accrue in the State of residence, since the taxpayers may file returns either at their place of residence or their place of business. A sample study of 1936 returns showed that 3.3 percent of returns, accounting for 3.4 percent of statutory income, were filed in States other than that of residence. Much the largest part of these was filed in the District of Co-

(Footnote continued on p. 208.)

lumbia (by residents of Virginia and Maryland) and in New York State (by residents of New Jersey and Connecticut). Treasury Department, Bulletin, October 1941, p. 52.

The estate and gift taxes were also allocated to the State of collection. The estate tax presumably falls partly on the decedent and partly on the beneficiary. It is normally collected in the State of residence of the decedent. Information concerning the State of residence of the beneficiary is not available. It seems probable, however, that a substantial part of this tax has been provided for by insurance, the premiums on which have been paid by the decedent during his lifetime, and that the larger part of the remainder was received by members of the immediate family or other beneficiaries living in the same State as the decedent. Consequently, the assumption that collections and incidence are the same should result in an assumed distribution of the burden that approximates the actual distribution. A 3-year average has been used so that any very exceptional collections that might arise in a single State in a single year will not seriously distort the results. No year is typical for any tax, but the relative changes among the different States from year to year, as long as the same laws are in force, are not as great for the other important taxes as for the estate tax.

Other taxes distributed in proportion to collections are the tax on unjust enrichment, which presumably falls on net income; narcotics taxes collected from wholesalers, retailers, and practitioners; admissions taxes; taxes on telephone and telegraph messages, and other small taxes. The incidence of the margarine taxes, unlike the incidence of other taxes on commodities, has also been assumed to be within the State of collection because of the extensive barriers that have been erected against interstate sales of this commodity.

The corporation taxes—income, capital stock, and excess profits—were distributed in proportion to income from dividends and interest, on the assumption that these taxes reduced dividend payments by the amount of tax collected, and that this reduction in dividend payments was in proportion to the dividend and interest payments received. (Interest was included with dividends because of the unavailability of separate data.) The other taxes distributed in proportion to income from dividends and interest are stamp taxes on stock and bond issues and transfers, and on silver bullion transfers.

It has been assumed that most of the manufacturers' excises, tobacco and liquor taxes, and other taxes on commodities have been shifted to the final consumer. Where data concerning consumption of the specific commodity are available, these have been used as the basis of distribution. Where these are not available, total retail sales have been substituted. (Retail sales figures are for the calendar year 1939 and tax collections are for the year ending June 30, 1940. Relative changes among States, however, should not have been great in this comparatively short period.) Insofar as such taxes are not shifted forward to the final consumer, the resulting distribution is, of course, inaccurate.

It is important to note in this connection that the bulk of these commodity taxes are collected from industries that are largely controlled by a small number of very large corporations, and that prices, in the main, are not, therefore, being determined competitively. The profits realized by these corporations have been substantial for the most part. Under these conditions, the complete shifting of the tax to the consumer is a more doubtful assumption than usual. The recent increases in Federal liquor taxes (October 1, 1941) were followed by reductions in prices by the National Distillers Products Corporation (reported in the New York Times, October 28, 1941) and other distillers and distributors. The spread between the wholesale and retail prices of cigarettes has permitted the absorption of State taxes of 1 cent or 2 cents a package in many instances. A record for one city (Poughkeepsie, N. Y.) showed that the recent 2-cent New York State cigarette tax was added to price by more than half of the merchants selling over the counter, and was taken out of the merchant's margin in about two-thirds of the cases where vending machines were used (unpublished study). The price of gasoline is lower today than it was 20 years ago when gasoline taxes were in their infancy. However, it is highly improbable that the prices that prevail for these commodities today would go unchallenged by serious competition if the entire spread between cost of production and final price were profits instead of being largely taxes.

In addition to the possibility that some of these taxes come from profits, there is a very real possibility that these corporations can shift part of the burden backward to sellers of raw materials and to labor, since their importance as buyers of both raw materials and labor gives them exceptional bargaining power. In either case the geographic incidence will vary somewhat from that assumed. Insofar as taxes come out of profits, the final incidence will be decreased somewhat in the poorer States. In the absence of further information, it seemed probable that the distribution in proportion to retail sales would be nearer the true incidence than any other assumption that might be made, but the limitations of this assumption are fully recognized.

For the taxes on employment, it has been assumed that the part paid by the employers is borne half by the stockholders of the corporation and half by the consumers of the products. The arguments concerning the shifting and incidence of this tax have been too frequently presented to need repetition here. It need only be noted that employers, employees, and consumers doubtless all share in the burden. Certainly they have all frequently protested that they do. (One actual investigation, quoted in S. E. Harris, Economics of Social Security, New York, 1941, p. 289, gives 75 businessmen reporting that the taxes have reduced profits against 2 reporting that they have not reduced profits; 25 reporting that they have prevented increases in wages against 49 reporting that they have not; 28 reporting that they have caused an increase in prices against 44 that they have not.) It is recognized that the extent and direction of shifting will vary with the industry, the individual firm, and the stage of the business cycle. In general, however, the difficulties of shifting any tax make it probable that a larger proportion of the employees' tax will be borne by them than would have been the case if the whole tax had been collected from employers, and that the employers will find it more difficult to shift their share to employees than to prevent the employees from shifting their own share to the employers. Also, the employees' share is less likely to reach consumers than the employers' share, since it is 1 step further removed. No brief is held, however, for the exact proportions of the tax that have been distributed here to these 3 groups.

Customs duties have been distributed in proportion to weighted retail sales on the assumption that the cost of transportation inland results in a smaller proportion of imported goods being consumed in States remote from the principal ports. To illustrate, one of the most important revenue producers is sugar; and it seems probable that New York, for instance, obtains most of its sugar from imported raw materials or semimanufactured products, whereas Utah would find it profitable to use local beet sugar even though there were no tariff. Insofar as the tariff is protective, consumers are paying more for goods than the Treasury receives. No attempt has been made to assess this burden.

For the tax burden as a whole, Alaskan, Hawaiian, Puerto Rican, and Philippine collections have been omitted. No allowance has been made, however, for the shifting of taxes collected in the United States to the residents of other countries who buy our products or obtain income from the United States. The amount may be appreciable, but so little information is available concerning the possible amount that it is believed that the error introduced by attempting to estimate it might be as great as the error in omitting it. Only if it altered the relative distribution among the different States would it be important for the purpose in hand.

In general these assumptions are similar to those made in other tax burden studies, although many minor variations will be found. (See Twentieth Century Fund, Studies in Current Tax Problems, New York, 1937, pp. 1-52; Temporary National Economic Committee, Monograph No. 3, Who Pays the Taxes, 1940; Social Security Board, Fiscal Capacity of the States, Bureau of Research and Statistics Memorandum, No. 43, 1941.)

A comparison of per capita Federal tax collections and incidence for the different States (given in table 20, p. 219) shows that the incidence is more evenly distributed than collections. This is primarily the result of the assumptions that taxes on commodities are shifted to final consumers, and corporation taxes to stockholders. The manufacturing plants and head offices of the big corporations, where most of those taxes are collected, are concentrated in a few localities. The consumers and stockholders are more evenly scattered in proportion to the total population than plants and offices.

When these taxes are reduced to percentages of income (tables 21 and 22, pp. 219 to 220) there is still wide variation, however, with Delaware leading the list. The personal income tax alone amounts to 11 percent of the income received by Delaware's residents. At the other end of the list is Arizona, with a tax burden of 2 percent. For the remaining States the burden varies from 5 to 10 percent (4.9 in Mississippi and 10.4 in Iowa). This is a much narrower range than is found for the majority of States when the ratio of collections to income is used as a measure of variation. Considerably more than half of the States lie outside the 5 to 10 percent range, when the ratio of collections to income is made a measure, and 9 lie outside the 2 to 20 percent range found for tax incidence.[26] There is some tendency for the industrial States to have a higher Federal tax burden, in proportion to income, than the agricultural States, but the difference is not marked.

When specific taxes are considered it is found that the proportion of taxes that is apparently shifted outside of the State of collection is 81 percent for tobacco taxes, 66 percent for automobile taxes, 44 percent for customs duties and gasoline taxes, 40 percent for stamp taxes, 33 percent for liquor taxes, 16 percent for corporation and electrical energy taxes, and 10 percent for pay-roll taxes.[27]

The geographic distribution of Federal tax collections is determined not only by the kind of tax and the industry subject to the tax, but also by the stage in the industrial process at which the levy is imposed. Such important taxes as those on liquor, tobacco, and gasoline will be collected largely in one group of States if they are levied on the manufacturer, as they are, and in a quite different group of States if they are levied on the producer of raw materials or on the retailer. The final incidence, however, is presumably much the same; although the shifting to the final consumer is apt to be more successful if the tax is imposed on the final stage of the industrial process rather than the initial stage.

If the net income derived from the industry is taxed instead of the commodity, both the collections and the incidence will be quite different from the collections or incidence of commodity taxes.

[26] The "percent of income represented by taxes collected within the State" has been computed to show the difference between collections and incidence, and does not imply that collections have, in fact, reduced income by this amount.

[27] This is on the assumptions (1) that taxes are shifted as assumed in table 19, (2) that consumers buy the products of their own States as far as these are available, and (3) that stockholders hold the stocks of the corporations paying taxes in their own States as far as these are available. The distribution of the tax burden is the same, of course, if the second and third assumptions do not hold, because the tax is uniform for the entire United States, and insofar as they buy the products of other States instead of their own, or invest in stocks of foreign corporations, they bear the same amount of tax. The amount of the tax shifted outside of the State of collection will increase to the extent that assumptions (2) and (3) do not hold.

TABLE 18.—*Federal taxes: Ranking of States according to per capita collections, 1940* [1]

Rank	Individual income		Corporation income		Employment		Estate and gift	
	State	Per capita tax	State	Per capita tax	State	Per capita tax	State	Per capita tax
1	Delaware	$92.61	Delaware	$154.25	Delaware	$16.32	Delaware	$16.93
2	Nevada	18.54	New York	20.95	New York	13.40	New York	7.60
3	New York	18.25	Michigan	15.96	Illinois	10.63	Rhode Island	7.03
4	Connecticut	15.55	Illinois	12.08	Connecticut	9.66	Connecticut	5.16
5	Maryland	11.63	Connecticut	11.22	Pennsylvania	8.46	Massachusetts	5.09
6	New Jersey	11.23	Ohio	10.69	Michigan	8.28	New Hampshire	4.51
7	Illinois	10.65	Nevada	10.25	Ohio	7.94	California	4.10
8	California	10.24	Missouri	9.29	Massachusetts	7.79	New Jersey	4.08
9	Florida	9.89	New Jersey	9.28	Maryland	7.47	Pennsylvania	3.82
10	Rhode Island	9.87	Pennsylvania	8.84	California	7.15	Florida	3.73
11	Massachusetts	9.53	California	8.79	Rhode Island	6.92	Ohio	3.02
12	Pennsylvania	8.49	Massachusetts	8.42	Missouri	6.80	Nevada	3.00
13	Michigan	8.11	Maryland	8.16	New Jersey	6.50	Maryland	2.82
14	Maine	7.26	Rhode Island	7.70	Minnesota	6.06	New Mexico	2.48
15	Ohio	7.02	Virginia	6.40	Nebraska	5.48	Michigan	2.47
16	Colorado	6.47	Minnesota	5.77	Nevada	4.79	Illinois	2.29
17	Missouri	5.68	Wisconsin	5.64	Washington	4.70	Maine	1.99
18	New Hampshire	4.88	Colorado	5.44	Colorado	4.64	Missouri	1.93
19	Texas	4.69	Texas	4.92	Wisconsin	4.55	Arizona	1.82
20	Indiana	4.27	Indiana	4.84	Oregon	4.54	Louisiana	1.69
21	Wyoming	4.23	North Carolina	4.61	Virginia	4.22	Vermont	1.51
22	Minnesota	4.05	Oklahoma	4.55	New Hampshire	4.16	Wisconsin	1.36
23	Washington	3.77	Washington	4.50	Maine	4.06	Oklahoma	1.29
24	Wisconsin	3.77	Maine	3.86	Vermont	3.89	Virginia	1.28
25	Virginia	3.76	Utah	3.78	Indiana	3.88	Minnesota	1.21
26	Louisiana	3.50	West Virginia	3.62	Kansas	3.84	Georgia	1.20
27	Vermont	3.14	Nebraska	3.53	Texas	3.29	Indiana	1.19
28	Oregon	3.04	Kentucky	3.47	Utah	3.21	Nebraska	1.15
29	North Carolina	2.87	Louisiana	3.45	West Virginia	3.03	Tennessee	1.01
30	Arizona	2.72	New Hampshire	3.43	Florida	2.89	Washington	.96
31	Tennessee	2.72	Florida	3.36	North Carolina	2.88	Wyoming	.86
32	Georgia	2.67	Georgia	3.30	Kentucky	2.84	Utah	.85
33	Oklahoma	2.65	Montana	3.14	Oklahoma	2.74	Iowa	.76
34	Montana	2.43	Vermont	3.07	Iowa	2.62	Kansas	.75
35	New Mexico	2.43	Iowa	3.04	Georgia	2.61	Texas	.73
36	Utah	2.34	Oregon	2.92	Tennessee	2.50	Alabama	.71
37	Nebraska	2.17	Tennessee	2.63	Montana	2.44	West Virginia	.67
38	West Virginia	2.15	Kansas	2.57	Idaho	2.41	Tennessee	.65
39	Kentucky	1.93	Idaho	2.40	Louisiana	2.39	Oregon	.58
40	Iowa	1.90	Wyoming	2.16	Wyoming	2.35	Montana	.54
41	Kansas	1.83	Arizona	2.03	Arizona	2.18	North Carolina	.51

42	Alabama	1.35	South Carolina	1.75	Alabama	2.04	South Carolina	.42
43	Idaho	1.17	Alabama	1.33	South Carolina	1.84	Idaho	.29
44	Arkansas	1.08	Arkansas	1.10	New Mexico	1.33	Colorado	.25
45	South Carolina	1.02	New Mexico	1.02	South Dakota	1.05	North Dakota	.24
46	Mississippi	.73	South Dakota	.80	Arkansas	1.02	Mississippi	.22
47	South Dakota	.73	Mississippi	.75	North Dakota	.96	Arkansas	.16
48	North Dakota	.54	North Dakota	.56	Mississippi	.83	South Dakota	.09

Rank	Liquor		Tobacco		Manufacturers' excises		Customs duties	
	State	Per capita tax	State	Per capita tax	State	Per capita tax	State	Per capita tax
1	Kentucky	$24.22	North Carolina	$80.13	Michigan	$13.64	New York	$13.39
2	Maryland	21.48	Virginia	66.31	Oklahoma	11.28	Massachusetts	9.10
3	Indiana	19.68	Kentucky	16.16	Rhode Island	6.10	Maryland	7.14
4	Illinois	10.62	New Jersey	8.30	Ohio	5.77	Louisiana	6.86
5	Wisconsin	9.10	Pennsylvania	2.41	New York	5.64	Vermont	4.17
6	Pennsylvania	7.08	Missouri	1.63	Pennsylvania	4.88	Virginia	3.65
7	New Jersey	6.38	Delaware	1.42	California	4.86	Rhode Island	3.52
8	Missouri	6.30	California	1.29	Texas	4.55	Arizona	3.12
9	California	5.22	Florida	1.25	Illinois	4.25	Pennsylvania	3.04
10	Minnesota	5.14	Tennessee	1.22	Maryland	4.10	North Carolina	2.89
11	Ohio	4.73	Ohio	.99	Connecticut	3.47	California	2.58
12	New York	4.57	West Virginia	.65	Missouri	2.67	Florida	2.43
13	Rhode Island	4.54	Illinois	.42	Kansas	2.57	Washington	2.37
14	Massachusetts	3.44	Michigan	.33	Louisiana	2.53	Texas	1.49
15	Louisiana	3.13	New Hampshire	.27	Indiana	2.12	Illinois	1.42
16	Michigan	3.09	New York	.25	Massachusetts	2.03	North Dakota	1.33
17	Washington	2.68	South Carolina	.20	Kentucky	1.87	Michigan	1.10
18	Connecticut	2.04	Connecticut	.13	Wisconsin	1.73	Oregon	1.06
19	Georgia	1.96	Louisiana	.09	Utah	1.24	Minnesota	1.01
20	Montana	1.77	Indiana	.08	Montana	1.22	Connecticut	.88
21	Colorado	1.53	Massachusetts	.04	New Jersey	1.21	Georgia	.85
22	Nebraska	1.37	Rhode Island	.03	Tennessee	1.18	South Carolina	.76
23	Wyoming	1.26	Wisconsin	.03	Minnesota	1.06	Missouri	.66
24	Utah	1.11	Maryland	.014	Colorado	1.03	Ohio	.62
25	Nevada	1.06	Iowa	.01	Wyoming	.76	Maine	.59
26	Delaware	.99	Maine	.01	Delaware	.68	Alabama	.44
27	Florida	.90	Minnesota	.006	Nebraska	.67	Indiana	.42
28	Oregon	.81	Utah	.005	New Mexico	.66	Nebraska	.39
29	Texas	.77	Georgia	.004	Arkansas	.63	Kentucky	.29
30	Arizona	.51	Texas	.004	Florida	.56	Wisconsin	.27
31	Virginia	.50	Nebraska	.003	Oregon	.54	Colorado	.24
32	Idaho	.44	Colorado	.002	Iowa	.49	Montana	.23
33	New Hampshire	.44	Alabama	.0009	Nevada	.47	Tennessee	.09

TABLE 18.—*Federal taxes: Ranking of States according to per capita collections, 1940*—Continued

Rank	Liquor		Tobacco		Manufacturers' excises		Cusoms duties	
	State	Per capita tax	State	Per capita tax	State	Per capita tax	State	Per capita tax
34	Iowa	.32	Oregon	.0009	Idaho	.45	Utah	.01
35	Tennessee	.29	Montana	.0007	Washington	.44	Iowa	.0008
36	Oklahoma	.21	South Dakota	.0006	New Hampshire	.39		
37	North Carolina	.19	Washington	.0006	Vermont	.38		
38	West Virginia	.14	Arkansas	.0005	Virginia	.38		
39	South Carolina	.11	Kansas	.0002	Maine	.36		
40	North Dakota	.10	Oklahoma	.00005	Georgia	.34		
41	South Dakota	.10			Arizona	.33		
42	Vermont	.10			Mississippi	.28		
43	Arkansas	.08			West Virginia	.28		
44	Kansas	.07			North Carolina	.26		
45	New Mexico	.07			South Dakota	.24		
46	Maine	.06			Alabama	.22		
47	Alabama	.04			North Dakota	.08		
48	Mississippi	.03			South Carolina	.06		

[1] Federal tax collections for fiscal year 1940; population as of Apr. 1, 1940.

Sources: Treasury Department, Annual Report of the Commissioner of Internal Revenue, 1940 and 1942; Annual Report of the Secretary, 1940.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*

[In thousands]

State	Corporation income, excess-profits, and capital-stock taxes		Personal income tax—collections and incidence [2]	Taxes on unjust enrichment—collections and incidence [3]
	Collections	Incidence [1]		
Alabama	$4,412	$6,494	$3,810	$30
Arizona	1,189	2,962	1,359	8
Arkansas	2,461	4,671	2,102	102
California	69,434	109,835	70,719	280
Colorado	6,999	9,571	7,261	22
Connecticut	21,299	33,156	26,579	53
Delaware	45,295	7,520	24,727	13
Florida	7,432	18,116	18,765	28
Georgia	11,435	11,849	8,341	150
Idaho	1,439	1,709	613	22
Illinois	109,789	83,744	84,083	1,070
Indiana	18,954	20,623	14,641	280
Iowa	8,758	13,558	4,817	322
Kansas	5,448	9,798	3,291	335
Kentucky	11,161	11,849	5,409	335
Louisiana	9,518	13,217	8,280	197
Maine	3,764	8,203	6,152	23
Maryland	16,714	26,092	21,175	90
Massachusetts	41,971	72,008	41,137	311
Michigan	93,138	38,511	42,623	383
Minnesota	18,394	17,204	11,308	232
Mississippi	1,917	4,557	1,584	20
Missouri	39,080	29,965	21,510	178
Montana	2,007	2,734	1,360	17
Nebraska	5,251	6,950	2,856	17
Nevada	1,282	1,709	2,039	13
New Hampshire	1,917	5,811	2,401	26
New Jersey	44,130	59,247	46,733	210
New Mexico	659	1,937	1,292	15
New York	318,868	273,227	246,026	1,071
North Carolina	18,257	14,014	10,245	183
North Dakota	434	1,481	346	8
Ohio	83,846	64,602	48,506	482
Oklahoma	12,331	12,191	6,184	234
Oregon	3,757	6,152	3,316	95
Pennsylvania	101,699	110,633	84,050	562
Rhode Island	6,339	11,052	7,036	54
South Carolina	3,845	4,102	1,931	74
South Dakota	610	1,709	471	4
Tennessee	8,852	10,596	7,929	237
Texas	36,200	47,626	30,073	303
Utah	2,407	2,962	1,286	16
Vermont	1,269	3,076	1,127	6
Virginia	18,924	14,242	10,060	128
Washington	9,110	12,191	6,536	119
West Virginia	7,915	7,862	4,083	91
Wisconsin	20,178	21,534	11,824	76
Wyoming	673	1,367	1,062	1
District of Columbia	7,016	13,558	9,607	10
Total	1,267,777	1,267,777	978,755	8,536

State	Estate and gift taxes—collections and incidence [3]	Liquor taxes		Tobacco taxes	
		Collections	Incidence [4]	Collections	Incidence [5]
Alabama	$1,604	$102	$4,427		$8,786
Arizona	394	256	2,245		1,883
Arkansas	294	153	3,118	$1	6,277
California	24,694	36,034	41,340	8,936	36,620
Colorado	2,678	1,722	4,801	2	4,705
Connecticut	11,497	3,484	10,226	220	10,247
Delaware	3,516	263	1,496	378	1,644
Florida	8,463	1,708	7,295	2,362	8,667
Georgia	2,424	612	3,180	11	9,945
Idaho	121	230	3,305		1,584
Illinois	24,112	83,842	43,834	3,291	46,656
Indiana	3,417	67,459	11,598	271	16,178
Iowa	1,956	800	12,845	28	9,501
Kansas	1,167	136	2,494		6,222
Kentucky	2,208	68,933	6,609	45,988	11,462
Louisiana	2,232	7,410	6,796	210	8,030

See footnotes at end of table.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*—Continued

[In thousands]

State	Estate and gift taxes—collections and incidence	Liquor taxes		Tobacco taxes	
		Collections	Incidence	Collections	Incidence
Maine	$1,889	$53	$2,806	$5	$4,090
Maryland	5,940	39,107	10,101	26	9,803
Massachusetts	20,722	14,835	22,572	186	26,019
Michigan	16,488	16,230	29,430	1,757	30,015
Minnesota	3,911	14,341	21,387	17	11,805
Mississippi	480	71	436		4,798
Missouri	8,268	23,846	12,096	6,168	16,340
Montana	230	990	6,609		1,909
Nebraska	1,354	1,802	6,173	4	4,595
Nevada	251	117	1,746		563
New Hampshire	1,506	215	1,746	133	2,511
New Jersey	17,374	26,530	31,800	34,516	20,626
New Mexico	625	37	1,559		1,443
New York	117,203	61,663	91,284	3,348	81,692
North Carolina	3,657	682	2,494	286,241	10,271
North Dakota	97	62	3,616		1,885
Ohio	18,300	32,679	49,196	6,836	34,080
Oklahoma	1,950	498	2,369		10,304
Oregon	760	883	6,173	1	5,158
Pennsylvania	35,443	70,126	64,597	23,871	45,723
Rhode Island	5,710	3,240	3,991	21	4,026
South Carolina	687	214	5,736	380	5,045
South Dakota	79	67	3,180		1,934
Tennessee	2,371	845	2,619	3,569	10,870
Texas	5,304	4,949	11,286	25	26,239
Utah	306	612	1,995	3	1,929
Vermont	619	37	998		1,954
Virginia	3,243	1,333	7,856	177,575	10,085
Washington	2,394	4,652	11,161	1	8,614
West Virginia	1,055	260	6,547	1,610	7,575
Wisconsin	4,965	28,553	28,121	80	12,793
Wyoming	271	316	1,933		930
District of Columbia	3,889	535	4,302		4,040
Total	378,318	623,524	623,524	608,071	608,071

State	Miscellaneous excises [6]		Oleomargarine, narcotics, etc., taxes [7]	
	Collections	Incidence	Collections	Incidence
Alabama	$135	$1,298	$73	$78
Arizona		491	18	19
Arkansas	16	903	43	46
California	11,804	9,659	2,126	2,136
Colorado	9,877	1,239	574	576
Connecticut	3,975	2,172	374	376
Delaware	31	333	11	11
Florida	49	1,860	163	166
Georgia	2,059	1,894	2,011	2,016
Idaho	130	533	9	10
Illinois	6,489	8,659	2,047	2,058
Indiana	3,146	3,230	700	696
Iowa	381	2,494	165	169
Kansas	122	1,433	172	175
Kentucky	466	1,576	78	82
Louisiana	6,869	1,473	55	58
Maine		851	37	39
Maryland	2,380	1,876	377	379
Massachusetts	6,906	5,266	1,451	1,456
Michigan	4,072	5,517	1,153	1,155
Minnesota	588	3,061	108	112
Mississippi	1	854	24	27
Missouri	425	3,342	2,346	2,332
Montana	8	673	15	16
Nebraska	46	1,203	980	982
Nevada		188	14	14
New Hampshire		552	17	18
New Jersey	6,073	4,787	844	705
New Mexico	11	382	9	10
New York	26,868	16,901	9,342	9,347
North Carolina	42	1,918	210	215
North Dakota		473	15	16
Ohio	17,878	7,396	1,606	1,615
Oklahoma	18	1,554	46	48
Oregon	8	1,339	70	72

See footnotes at end of table.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*—Continued

[In thousands]

State	Miscellaneous excises		Oleomargarine, narcotics, etc., taxes	
	Collections	Incidence	Collections	Incidence
Pennsylvania	$9,591	$9,492	$1,803	$1,811
Rhode Island	13	833	23	24
South Carolina		1,006	54	57
South Dakota	1	512	13	14
Tennessee	218	1,836	67	71
Texas	1,643	5,463	399	405
Utah	3,518	518	11	12
Vermont	1	373	13	14
Virginia	223	1,903	325	330
Washington	93	2,027	144	147
West Virginia	559	1,224	227	230
Wisconsin	601	3,227	555	571
Wyoming		301	9	9
District of Columbia	2	1,221	226	227
Total	127,336	127,336	31,152	31,152

State	Stamp taxes other than on playing cards [3]		Gasoline, oil pipe line, and lubricating oil taxes	
	Collections	Incidence	Collections	Incidence [4]
Alabama	$60	$172	$239	$2,944
Arizona	29	79		1,295
Arkansas	42	125	1,025	2,075
California	1,507	2,929	28,742	20,842
Colorado	146	255	520	2,601
Connecticut	198	884	434	4,305
Delaware	136	200	70	784
Florida	156	483	413	4,356
Georgia	126	316	586	4,242
Idaho	26	46	102	1,046
Illinois	2,076	2,234	23,847	17,213
Indiana	219	550	679	8,205
Iowa	170	362	.78	6,312
Kansas	78	261	4,286	5,488
Kentucky	115	316	4,657	3,184
Louisiana	157	352	5,961	2,969
Maine	54	219	14	1,863
Maryland	195	696	6,231	3,585
Massachusetts	1,026	1,921	4,616	8,479
Michigan	442	1,027	2,913	14,397
Minnesota	198	459	1,469	6,342
Mississippi	40	122	229	2,331
Missouri	377	799	9,324	7,733
Montana	36	73	531	1,569
Nebraska	80	185	521	2,636
Nevada	21	46		510
New Hampshire	23	155		1,078
New Jersey	622	1,580	202	10,556
New Mexico	24	52	266	1,269
New York	21,186	7,288	55,145	22,392
North Carolina	122	374	443	5,237
North Dakota	18	40	6	1,534
Ohio	797	1,723	11,045	16,639
Oklahoma	139	325	28,138	4,679
Oregon	116	164		2,878
Pennsylvania	1,423	2,951	42,872	17,919
Rhode Island	87	295	88	1,652
South Carolina	7	109	12	2,637
South Dakota	19	46	11	1,549
Tennessee	121	283	769	3,729
Texas	450	1,270	30,341	15,469
Utah	39	79	499	1,077
Vermont	16	82	12	784
Virginia	144	380	137	4,601
Washington	246	325	250	4,216
West Virginia	59	210	277	2,390
Wisconsin	270	574	778	6,778
Wyoming	13	36	132	771
District of Columbia	163	362	16	1,786
Total	33,814	33,814	268,926	268,926

See footnotes at end of table.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*—Continued

[In thousands]

State	Manufacturers' excises on automobiles and parts		Electrical energy tax		Admissions and dues taxes, collections and incidence [2]
	Collections	Incidence [10]	Collections	Incidence [11]	
Alabama	$38	$1,278	$330	$1,276	$115
Arizona	1	524	164	430	36
Arkansas	1	946	217	75	55
California	2,537	10,174	2,614	3,054	2,879
Colorado	287	1,332	341	246	143
Connecticut	761	1,792	773	643	435
Delaware	2	266	80	5	71
Florida	5	1,766	632	372	503
Georgia	11	1,840	426	522	188
Idaho	----------	604	132	365	15
Illinois	2,534	7,176	3,400	2,664	2,563
Indiana	2,797	3,734	1,035	1,446	382
Iowa	273	2,981	777	683	179
Kansas	2	2,218	384	414	71
Kentucky	24	1,710	453	296	185
Louisiana	10	1,336	442	610	218
Maine	7	785	282	283	62
Maryland	571	1,656	621	694	450
Massachusetts	1,391	3,369	1,857	1,120	1,350
Michigan	65,229	5,682	1,884	1,956	932
Minnesota	307	3,268	730	543	559
Mississippi	225	958	165	22	25
Missouri	501	3,396	1,190	520	582
Montana	1	714	175	510	25
Nebraska	15	1,585	346	260	109
Nevada	----------	163	52	600	13
New Hampshire	----------	508	190	236	61
New Jersey	243	4,010	2,087	1,498	807
New Mexico	----------	476	84	91	18
New York	9,925	10,354	7,346	5,609	9,396
North Carolina	23	2,264	464	806	160
North Dakota	1	686	44	73	10
Ohio	23,182	7,358	2,458	2,700	1,113
Oklahoma	5	2,179	508	360	144
Oregon	12	1,451	566	480	134
Pennsylvania	2,321	8,021	3,602	3,577	1,633
Rhode Island	44	682	298	237	257
South Carolina	1	1,237	106	508	81
South Dakota	----------	740	143	52	12
Tennessee	2,395	1,671	119	662	193
Texas	52	6,322	1,464	1,224	702
Utah	3	523	195	138	49
Vermont	----------	352	124	195	17
Virginia	23	1,805	845	607	200
Washington	47	2.104	445	1,118	247
West Virginia	2	1,126	240	1,042	84
Wisconsin	3,600	3,309	1,013	965	304
Wyoming	----------	327	63	46	18
District of Columbia	4	645	288	361	339
Total	119,403	119,403	42,194	42,194	28,124

State	Employment taxes		Customs duties	
	Collections	Incidence [12]	Collections	Incidence [13]
Alabama	$5,778	$6,309	$1,253	$3,024
Arizona	1,090	2,116	1,558	1,683
Arkansas	1,986	3,710	----------	1,548
California	49,366	61,712	17,853	33,128
Colorado	5,215	6,384	268	2,120
Connecticut	16,517	17,578	1,502	7,450
Delaware	4,357	4,122	----------	1,143
Florida	5,474	9,904	4,616	6,380
Georgia	8,146	9,496	2,666	4,333
Idaho	1,263	2,008	----------	914
Illinois	83,966	63,507	11,212	20,700
Indiana	13,293	16,697	1,456	7,387
Iowa	6,648	10,866	2	4,270
Kansas	6,915	6,377	----------	2,452
Kentucky	8,082	8,061	821	2,701
Louisiana	5,639	8,137	16,216	5,050
Maine	3,436	4,749	499	1,943

See footnotes at end of table.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*—Continued

[In thousands]

State	Employment taxes		Customs duties	
	Collections	Incidence	Collections	Incidence
Maryland	$13,604	$13,031	$13,004	$6,431
Massachusetts	33,608	39,880	39,301	18,058
Michigan	43,496	37,804	5,798	18,920
Minnesota	16,909	14,560	2,831	10,567
Mississippi	1,810	3,488		1,953
Missouri	25,724	21,240	2,512	7,637
Montana	1,363	2,552	131	1,538
Nebraska	7,214	5,377	514	2,057
Nevada	526	956		322
New Hampshire	2,046	3,262		1,268
New Jersey	27,030	33,558		16,416
New Mexico	705	1,513		873
New York	180,638	157,806	180,450	57,965
North Carolina	10,288	10,731	10,335	6,577
North Dakota	614	1,569	853	1,621
Ohio	54,863	49,349	4,289	16,905
Oklahoma	6,391	8,500		2,660
Oregon	4.954	6,092	1,154	4,592
Pennsylvania	83,739	72,034	30,069	32,557
Rhode Island	4,936	6,170	2,512	2,857
South Carolina	3,487	4,433	1,438	2,307
South Dakota	678	1,726		873
Tennessee	7,304	8,811	270	3,148
Texas	21,087	28,494	9,553	18,731
Utah	1,768	2,411	8	883
Vermont	1,397	1,948	1,496	1,278
Virginia	11,307	10,049	9,763	6,525
Washington	8,165	10,282	4,119	6,951
West Virginia	5,759	6,679		2,795
Wisconsin	14,290	17,386	861	7,377
Wyoming	591	1,180		520
District of Columbia	8,353	7,211		2,795
Total	831,815	831,815	381,183	381,183

State	Total taxes collected	Total incidence of taxation	Difference between incidence and collections
Alabama	$17,979	$41,645	$23,666
Arizona	6,102	15,524	9,422
Arkansas	8,498	26,047	17,549
California	329,525	430,001	100,476
Colorado	36,055	43,934	7,879
Connecticut	88,101	127,393	39,292
Delaware	78,950	45,851	−33,099
Florida	50,769	87,124	36,355
Georgia	39,192	60,736	21,544
Idaho	4,102	12,895	8,793
Illinois	444,621	419,573	−25,048
Indiana	128,729	109,064	−19,665
Iowa	25,354	71,315	45,961
Kansas	22,407	42,196	19,789
Kentucky	149,005	56,073	−92,932
Louisiana	63,414	58,955	−4,459
Maine	16,277	33,957	17,680
Maryland	120,485	101,999	−18,486
Massachusetts	210,658	263,668	53,010
Michigan	296,538	244,840	−51,698
Minnesota	71,902	105,338	33,436
Mississippi	6,591	21,655	15,064
Missouri	142,031	135,938	−6,093
Montana	6,889	20,529	13,640
Nebraska	21,109	36,339	15,230
Nevada	4,328	9,133	4,805
New Hampshire	8,535	21,139	12,604
New Jersey	207,401	249,907	42,506
New Mexico	3,645	11,455	7,810
New York	1,248,475	1,107,561	−140,914
North Carolina	341,352	69,146	−272,206
North Dakota	2,508	13,455	10,947
Ohio	307,880	319,964	12,084

See footnotes at end of table.

TABLE 19.—*Federal taxes: Collections and incidence, by States, 1940*—Continued

[In thousands]

State	Total taxes collected	Total incidence of taxation	Difference between incidence and collections
Oklahoma	$56, 586	$53, 681	-$2, 905
Oregon	15, 826	38, 856	23, 030
Pennsylvania	492, 804	491, 003	-1, 801
Rhode Island	30, 658	44, 876	14, 218
South Carolina	12, 317	29, 950	17, 633
South Dakota	2, 108	12, 901	10, 793
Tennessee	35, 259	55, 026	19, 767
Texas	142, 545	198, 911	56, 366
Utah	10, 720	14, 184	3, 464
Vermont	6, 134	12, 823	6, 689
Virginia	234, 230	72, 014	-162, 216
Washington	36, 568	68, 432	31, 864
West Virginia	22, 221	42, 993	20, 772
Wisconsin	87, 948	119, 804	31, 856
Wyoming	3, 149	8, 772	5, 623
District of Columbia	30, 448	50, 353	19, 905
Total	5, 728, 928	5, 728, 928	

Source: Collections are for fiscal year 1940 and are from Annual Report of the Secretary of the Treasury, 1940, and Annual Report of the Commissioner of Internal Revenue, 1940.

[1] Distributed among the States in proportion to income payments from dividends and interest as reported in Survey of Current Business, August 1941. 1940 figures have been used.

[2] Distributed in proportion to collections.

[3] Distributed in proportion to collections. Because of the wide variation in this tax from year to year, and the fact that insofar as it is borne by the decedent it is spread over several years, the average of collections for 1938, 1939, and 1940 have been used in place of 1940 collections.

[4] Distributed in proportion to 1939 retail sales of package liquor stores and drinking places.

[5] Distributed by increasing estimated distribution of tax in 1935 (Social Security Board, Fiscal Capacity of States, pp. 1-45. This estimate was based on data in the 1935-36 Study of Consumer Purchases) in proportion to the increase in income in the different States. The total thus obtained was then adjusted to the total tax collections of 1940 by applying the ratio of the second to the first total to the figure for each State.

[6] Manufacturers' excises on mechanical refrigerators, radios, matches, toilet preparations, furs, sporting goods, cameras, chewing gum, brewers' wort, malt, firearms, pistols; stamp tax on playing cards; national firearms tax; taxes on coconut and other oils, bituminous coal, sugar. The taxes on chewing gum, malt, brewers' wort, furs, sporting goods, and cameras were repealed as of June 30, 1938. Distributed in proportion to 1939 retail sales of all commodities.

[7] Includes, also, taxes on adulterated butter, mixed flour, filled cheese, marihuana; telegraph, telephone, and cable messages; leased wires; safe-deposit boxes; and other miscellaneous items. The interstate restrictions on margarine sales are so general that it seemed improbable that any large part of these taxes could be shifted to consumers in other States. Consequently, these have been assumed to fall where they are collected. The largest part of the narcotics taxes is paid by retailers and practitioners. Consequently, these have been assumed to fall in the State of collection. The opium tax has been distributed in proportion to the population. All the other taxes (all of them small in amount) have been assumed to fall where they are collected.

[8] Stamp taxes on stock and bond issues and transfers, and silver bullion transfers. Distributed in proportion to 1940 income payments from interest and dividends. The largest part of the revenue is from sales of stocks and bonds.

[9] One-half of the tax on lubricating oil is distributed in proportion to manufacturing costs (cost of materials, supplies, fuel, electrical energy, and contract work) on the assumption that it is used in manufacturing. The gasoline tax, the tax on oil pipe lines, and half of the tax on lubricating oil have been distributed in proportion to 1939 motor-fuel consumption.

[10] Distributed in proportion to motor vehicle registrations for 1939.

[11] Distributed in proportion to electrical energy production for 1939.

[12] Taxes on employees have been distributed in proportion to collections, on the assumption that employees live in the State of collection and are unable to shift the taxes to others. Taxes on employers were distributed, half in proportion to retail sales, and half in proportion to income from dividends and interest, on the assumption that these taxes are shifted half to consumers and half to stockholders.

[13] Distributed in proportion to weighted retail sales. On the assumption that the cost of transportation inland results in a smaller proportion of imported goods being consumed in States remote from the principal ports, retail sales have been weighted as follows:

2 to States that had customs collections in excess of $1 per capita in 1940 (Arizona, California, Florida, Illinois, Louisiana, Maryland, Massachusetts, Michigan, Minnesota, New York, North Carolina, North Dakota, Oregon, Pennsylvania, Rhode Island, Texas, Vermont, Virginia, Washington) and States close to large ports in other States (Connecticut, Delaware, New Jersey).

1½ to States that had customs collections of 50 cents to $1 per capita (Georgia, Maine, Missouri, South Carolina) and States within relatively easy reach of large ports in other States (Alabama, District of Columbia, Indiana, Mississippi, Montana, New Hampshire, New Mexico, Ohio, West Virginia, Wisconsin).

1 to States with customs collections of less than 50 cents per capita and also remote from important ports in other States (Arkansas, Colorado, Idaho, Iowa, Kansas, Kentucky, Nebraska, Nevada, Oklahoma, South Dakota, Tennessee, Utah, Wyoming).

TABLE 20.—*Total Federal taxes: States ranked according to per capita collections and incidence, 1940* [1]

Rank	Collections		Incidence	
	State	Amount	State	Amount
1	Delaware	$247	Delaware	$172
2	North Carolina	95	Nevada	83
3	New York	92	New York	82
4	Virginia	88	Connecticut	75
5	Maryland	64	Rhode Island	63
6	Michigan	56	California	62
7	Indiana	56	Massachusetts	61
8	Kentucky	52	New Jersey	60
9	Pennsylvania	50	Maryland	56
10	Connecticut	50	Illinois	53
11	New Jersey	50	Pennsylvania	50
12	Massachusetts	49	Florida	46
13	California	48	Michigan	46
14	Ohio	45	Ohio	46
15	Rhode Island	42	New Hampshire	43
16	Nevada	39	Maine	40
17	Illinois	38	Colorado	39
18	Missouri	37	Washington	39
19	Wisconsin	28	Minnesota	38
20	Louisiana	28	Wisconsin	38
21	Florida	26	Montana	37
22	Minnesota	26	Missouri	36
23	Oklahoma	25	Oregon	36
24	Texas	22	Vermont	36
25	Washington	21	Wyoming	35
26	Utah	20	Indiana	32
27	Maine	19	Arizona	31
28	New Hampshire	19	Texas	31
29	Vermont	17	Iowa	28
30	Nebraska	16	Nebraska	28
31	Oregon	14	Virginia	27
32	Arizona	13	Utah	26
33	Georgia	13	Louisiana	25
34	Kansas	12	Idaho	24
35	Wyoming	12	Kansas	23
36	Montana	12	Oklahoma	23
37	Tennessee	12	West Virginia	23
38	West Virginia	12	New Mexico	22
39	Iowa	10	North Dakota	21
40	New Mexico	8	Kentucky	20
41	Idaho	8	South Dakota	20
42	South Carolina	6	Georgia	19
43	Alabama	6	North Carolina	19
44	Arkansas	4	Tennessee	19
45	North Dakota	4	South Carolina	16
46	Colorado	3	Alabama	15
47	South Dakota	3	Arkansas	13
48	Mississippi	3	Mississippi	10

[1] Computed from table 19, population as of Apr. 1, 1940.

TABLE 21.—*Total Federal taxes: Collections as percentage of total income by States, 1940.*

State	Total income (for taxes collected) [1]	Total taxes collected [2]	Percent of income	State	Total income (for taxes collected) [1]	Total taxes collected [2]	Percent of income
	Millions	*Millions*			*Millions*	*Millions*	
Alabama	$733	$18	2.45	Connecticut	$1,454	$88	6.06
Arizona	739	6	.82	Delaware	266	79	29.68
Arkansas	491	8	1.73	Florida	884	51	5.74
California	5,664	330	5.82	Georgia	988	39	3.97
Colorado	629	36	5.73	Idaho	244	4	1.68

[1] The income figures for collections are the average income payments for 1939 and 1940 (reported in Survey of Current Business, August, 1941), increased by the amount of tax collections, other than those levied on income (i. e., personal income, estate, and gift taxes, and pay-roll tax on employees). Insofar as these taxes are shifted outside of the State, they do not, of course, reduce the realized income to the extent that this procedure implies.

[2] Collections are for fiscal year 1940 and are from Annual Report of the Secretary of the Treasury, 1940, and Annual Report of the Commissioner of Internal Revenue, 1940.

TABLE 21.—*Total Federal taxes: Collections as percentage of total income by States, 1940*—Continued

State	Total income (for taxes collected)	Total taxes collected	Percent of income	State	Total income (for taxes collected)	Total taxes collected	Percent of income
	Millions	*Millions*			*Millions*	*Millions*	
Illinois	$5,588	$445	7.96	North Carolina	$1,444	$341	23.64
Indiana	1,917	129	6.72	North Dakota	238	2	1.05
Iowa	685	25	3.70	Ohio	4,536	308	6.79
Kansas	743	22	3.02	Oklahoma	857	56	6.60
Kentucky	1,039	149	14.34	Oregon	630	16	2.51
Louisiana	879	63	7.21	Pennsylvania	6,284	493	7.84
Maine	424	16	3.84	Rhode Island	531	31	5.77
Maryland	1,246	120	9.67	South Carolina	548	12	2.25
Massachusetts	3,306	211	6.37	South Dakota	255	2	.83
Michigan	3,514	296	8.44	Tennessee	952	35	3.70
Minnesota	1,480	72	4.86	Texas	2,821	142	5.05
Mississippi	439	6	1.50	Utah	271	11	3.96
Missouri	1,948	142	6.29	Vermont	196	6	3.13
Montana	318	7	2.17	Virginia	1,091	234	2.15
Nebraska	583	21	3.62	Washington	1,077	36	3.40
Nevada	103	4	4.20	West Virginia	780	22	2.85
New Hampshire	275	8	3.10	Wisconsin	1,928	88	4.56
New Jersey	3,030	207	6.84	Wyoming	165	3	1.91
New Mexico	184	4	1.98	District of Columbia	839	30	3.63
New York	12,104	1,248	10.31				

TABLE 22.—*Total Federal taxes: Incidence as percentage of income by States, 1940*

State	Total income for taxes borne[1]	Total taxes borne[2]	Percent of income	State	Total income for taxes borne[1]	Total taxes borne[2]	Percent of income
	Millions	*Millions*			*Millions*	*Millions*	
Alabama	$731	$42	5.70	Nevada	$103	$9	8.56
Arizona	739	16	2.10	New Hampshire	278	21	7.60
Arkansas	492	26	5.29	New Jersey	2,971	250	8.41
California	5,586	430	7.70	New Mexico	184	11	6.23
Colorado	617	44	7.12	New York	11,622	1,108	9.53
Connecticut	1,441	127	8.84	North Carolina	1,137	69	6.08
Delaware	226	46	20.29	North Dakota	238	13	5.66
Florida	885	87	9.84	Ohio	4,395	320	7.28
Georgia	978	61	6.21	Oklahoma	826	54	6.50
Idaho	243	13	5.31	Oregon	628	39	6.19
Illinois	5,383	420	7.79	Pennsylvania	6,119	491	8.02
Indiana	1,837	109	5.94	Rhode Island	514	45	8.73
Iowa	686	71	10.40	South Carolina	527	30	5.68
Kansas	735	42	5.74	South Dakota	249	13	5.18
Kentucky	915	56	6.13	Tennessee	926	55	5.94
Louisiana	844	59	6.98	Texas	2,724	199	7.30
Maine	427	34	7.95	Utah	263	14	5.39
Maryland	1,188	102	8.58	Vermont	189	13	6.78
Massachusetts	3,260	264	8.09	Virginia	1,053	72	6.84
Michigan	3,343	245	7.32	Washington	1,036	68	6.60
Minnesota	1,449	105	7.32	West Virginia	755	43	5.69
Mississippi	441	22	4.91	Wisconsin	1,858	120	6.45
Missouri	1,881	136	7.23	Wyoming	161	9	5.45
Montana	316	20	6.50	District of Columbia	841	50	5.99
Nebraska	576	36	6.31				

[1] The income figures for incidence are the average income payments for 1939 and 1940 (reported in Survey of Current Business, August 1941), increased by the corporation income and excess profits taxes, the stamp taxes on securities, and the pay-roll taxes assumed to be borne by the owners of the business, since these taxes presumably reduce income payments rather than the income after it has been received.

[2] From table 19.

7. TERRITORIAL SHIFTING OF STATE TAXES

The burden of State taxes, as well as Federal taxes, may sometimes be shifted outside of the State in which the taxes are collected. The shifting is not as great as in the case of Federal taxes, partly because of constitutional restrictions on the taxation of interstate commerce, partly because the unequal tax burdens themselves will operate as a check insofar as the tax base is mobile. Nevertheless, the possibilities of shifting the State tax burden to the citizens of other States are very real.

A State with a monopoly of an important natural resource should have an exceptional opportunity to tax nonresident consumers. Texas and Oklahoma, for instance, have taken advantage of their near-monopoly of petroleum production to the extent of obtaining approximately 15 percent of State tax revenues from a severance tax on oil. Other States have achieved a monopoly of some important business through accidental circumstances or because exceptional transportation facilities and a large population offer unusual advantages. New York City's virtual monopoly of certain branches of finance is an instance of this; and New York State's stock-transfer tax, which yielded 5 percent of the State's tax revenues in 1940, and has produced as much as 15 percent in better years, is another instance of a State tax that is probably shifted for the most part to the citizens of other States.

Some States have certain advantage of location—lying across some important trade route. Some of the sparsely settled Mountain States separating the Middle West from the Pacific coast are obstacles to transcontinental railroad and motor-vehicle traffic, probably costing more than they contribute to such traffic. Yet, like the barons of the Rhine in medieval times, they are in a position to levy heavy toll on this traffic. And some have taken advantage of this position. Many of the interstate trade barriers that have aroused so much discussion recently have been barriers imposed by these States on through motor-vehicle traffic.

States have sometimes attempted to attract more taxable wealth than their natural advantages would bring, through the granting of special privileges. The Delaware corporation law, which offers exceptionally broad powers, is an instance of this. Sometimes low taxes are used as bait, but this device tends to be self-defeating, since taxes low enough to attract industry when there are no other special advantages will usually be too low to bring in large revenues.

8. REGIONAL DISTRIBUTION OF GOVERNMENT EXPENDITURE

Turning to the expenditure side of the account, Federal Government payments are necessarily very unequally distributed. Insofar as they are designed to give aid to regions too poor to support the minimum standard of government services, they may be expected to accumulate in the poorer areas. When they require spending on the part of the State or locality they will, on the contrary, tend to be larger in the wealthier regions—those that can best afford the necessary local contribution. War contracts must go where the facilities for executing them are greatest. There has been some demand for spreading these contracts over the entire country, but the urgency of the need prevents any extensive and deliberate scattering of contracts, and they have been pretty well concentrated in a few manufacturing States.

Federal expenditures specifically designed to aid the States accounted for about 44 percent of all Federal expenditures in 1940.[28] When these are reduced to a per capita basis wide variations are found. The results for the different States are given in table 23.

TABLE 23.—*Ranking of States according to per capita Federal grants and expenditures, 1940* [1]

State	Grants and expenditures		Expenditures		Grants	
	Amount	Rank	Amount	Rank	Amount	Rank
Nevada	$88.68	1	$64.35	4	$24.33	1
Montana	81.46	2	70.02	2	11.44	4
North Dakota	79.02	3	74.39	1	4.70	24
Wyoming	78.22	4	62.75	5	15.48	2
South Dakota	75.39	5	68.72	3	6.67	11
Idaho	69.96	6	60.62	6	9.35	7
Nebraska	59.71	7	54.00	7	5.71	15
New Mexico	56.89	8	49.53	8	7.36	9
Colorado	54.48	9	42.90	9	11.59	3
Arizona	51.49	10	40.91	10	10.58	5
Utah	48.63	11	39.11	11	9.52	6
Iowa	42.56	12	37.84	12	4.72	23
Kansas	42.04	13	37.68	13	4.36	28
Oregon	40.88	14	33.35	17	7.53	8
Oklahoma	39.92	15	34.00	16	5.91	14
Arkansas	39.68	16	36.06	14	3.62	37
Minnesota	38.13	17	32.49	18	5.64	16
Mississippi	36.93	18	34.08	15	2.85	44
Washington	35.20	19	28.75	20	6.46	12
Texas	35.14	20	31.10	19	3.95	33
Missouri	32.96	21	28.30	22	4.67	25
South Carolina	31.43	22	28.65	21	2.78	45
Louisiana	31.36	23	27.56	23	3.82	35
Indiana	31.20	24	26.08	25	5.11	21
Wisconsin	29.92	25	25.07	27	4.85	22
Illinois	29.90	26	25.74	26	4.16	30
Alabama	29.75	27	27.09	24	2.66	46
California	27.91	28	20.73	36	7.18	10
Ohio	27.28	29	22.71	29	4.57	27
Massachusetts	26.75	30	21.14	31	5.61	18
New Hampshire	26.46	31	21.22	30	5.23	20
Georgia	25.99	32	23.39	28	2.60	47
Vermont	25.60	33	20.13	37	5.48	19
Rhode Island	25.43	34	20.79	35	4.64	26
Michigan	25.13	35	20.88	33	4.25	29
Florida	24.98	36	21.08	32	3.90	34
West Virginia	24.29	37	20.85	34	3.44	40
Tennessee	23.06	38	19.47	39	3.59	38
Kentucky	22.56	39	19.70	38	2.86	43
Delaware	22.44	40	16.09	44	6.36	13
Maine	21.91	41	16.27	43	5.63	17
New Jersey	21.76	42	18.39	40	3.37	41
Pennsylvania	21.39	43	17.42	42	3.97	32
North Carolina	21.06	44	17.81	41	3.25	42
Connecticut	19.28	45	15.18	46	4.10	31
Maryland	18.80	46	15.02	45	3.78	36
New York	18.17	47	14.65	47	3.52	39
Virginia	17.23	48	14.64	48	2.59	48

[1] Grants and expenditures from Annual Report of the Secretary of the Treasury, 1940. Population as of Apr. 1, 1940.

The greatest variation is found in the grant figures—Nevada receiving nearly 10 times as much per capita as Virginia. For expenditures made by Federal agencies within States the range is much less—North Dakota receiving about 5 times the amount that Virginia receives. The figures show quite different distributions for the two types of expenditures. Virginia is at the bottom of both lists, but North Dakota leads in expenditures within the State and ranks only

[28] The expenditures are described as "direct payments to States under cooperative arrangements and expenditures within States which provided relief and other aid during the fiscal year 1940" (Treasury Department, Annual Report of the Secretary, 1940, pp. 822 ff.).

twenty-fourth in grants to States; and Maine ranks seventeenth in grants and forty-third in expenditures within the States. These are the extreme cases, but there are a number of other instances where the rank of the State varies widely in the two series.

When both forms of expenditure are combined the range is still wide—the State with the highest per capita figure (Nevada) receiving five times the amount received by the State with the lowest per capita figure (Virginia). (See table 23, p. 222.) A comparison of these figures with figures for per capita income in the different States shows some inverse correlation. That is, some equalization of resources is found. There are, however, some important exceptions.

When the States are grouped in quartiles, according to per capita income, it appears that per capita grants tend to be highest in the second quartile and to decline in the third and fourth quartiles. This is shown in table 24. The largest part of these grants is the percentage grants under the Social Security Act. This suggests that States in the upper half of the income group are able to take full advantage of the percentage grants, and that Federal contributions increase with need. In the lower half of the income group the trend is reversed. The poorer States are unable to meet the social-security grant requirements, and consequently Federal contributions decrease with the ability of the State to contribute instead of increasing with the need of the State for assistance.

TABLE 24.—*Comparison of Federal taxes and Federal expenditures for States grouped according to per capita income, 1940*

[Median figure for each quartile]

Income quartile [1]	Taxes [2]		Defense contract awards [3]	Grants and expenditures [4]	Grants [4]	Expenditures [4]	Taxes as percent of income	
	Collections	Incidence					Collections	Incidence
First	$49	$62	$107	$25	$4	$20	6.82	8.50
Second	19	38	56	33	6	27	3.62	6.81
Third	13	28	30	42	5	38	3.32	6.02
Fourth	11	19	20	31	3	28	3.07	6.01

[1] Computed from data in Survey of Current Business, August 1941.
[2] Computed from table 19 (pp. 213–18).
[3] Computed from data in Dun's Review, June 1941, p. 6. The figures are for defense contracts for the 11 months, June 1, 1940, to Apr. 30, 1941. Contracts amounted to $10,800,000,000, compared with $3,900,000,000 for grants and expenditures for aid.
[4] Computed from data in Annual Report of the Secretary of the Treasury, 1940.

Grant expenditures within States (and combined grants and expenditures within States, since the latter are much the larger part of the total) tend to increase as the per capita income declines in the three highest quartiles. Even these decline, however, for the lowest quartile, although these are the Federal expenditures specifically designed to aid the poorer areas. A comparison of Federal expenditures per capita with Federal taxes per capita indicates that the Federal Government is taxing in accordance with ability more successfully than it is spending in accordance with need.

Examination of the data for individual States reveals some interesting instances of the failure of Federal expenditures to vary with need. Nevada is an extreme case. This State is reported as having the highest per capita income of any State in 1940. The $960 average is nearly $100 higher than the average of its nearest competitor, Connecticut, and almost four times the Mississippi figure. Federal tax collections and incidence reflect this high income fairly well. Nevada is close to the top of the list in both per capita corporation tax and personal income-tax collections. Not being a manufacturing State it is low in excises, and ranks fifteenth for all taxes combined. But when incidence rather than collections is used as a measure, the State rises to second place, being exceeded only by Delaware.

If Federal-aid expenditures were in proportion to need, and if lack of per capita income could be accepted as an adequate measure of need, Nevada should be at the bottom of the list when States are ranked according to per capita Federal-aid expenditures. In fact, it is at the top, with an $89 per capita Federal-aid expenditure. This exceeds the estimated Federal tax incidence by $6. In other words, if these estimates are correct, the State with the highest per capita income receives more in aid expenditures from the Federal Government than it pays in taxes to the Federal Government. Civilian Conservation Corps expenditures are largely responsible for the very high total, and these are not primarily for the benefit of the State's residents. However, per capita Work Projects Administration expenditures are as high as the average for the whole country, social-security grants are twice as high as the national average, and highway grants are approximately 15 times as high. These are the most important Government aids. The 1940 figures are not exceptional. Nevada has received much the same amount for several years.

There are no other instances comparable to this, but only 2 (South Dakota and New Mexico) of the 12 States in the lowest income quartile are in the highest quartile when the States are ranked according to aid. On the other hand, all but 3 of the States (Missouri, Florida, and Virginia) whose tax contribution apparently exceeded their receipts from Federal aid were in the upper half of the income group. The distribution among States has varied widely from one year to the next, not so much because of changes in relative need as because of changes in the form of Federal payments as the Federal Emergency Relief Administration gave way to the Work Projects Administration, as shifts were made in the farm program, and as social-security percentage grants and other new forms of aid were introduced.

For some time the pattern of Federal expenditures has been dominated by defense and war contracts. These are of a different nature from the depression aids, of course, since they go to private business concerns rather than to those in need; but they increase employment, and are welcomed by the communities in which the business concerns are located with almost the same enthusiasm with which the business enterprises greet them.

Expenditures at State and local levels in any particular area may benefit other geographic areas, just as taxes at the State and local levels may be drawn from outside the taxing jurisdiction. Highways, which are still largely in State and local hands, are an obvious case of this. One State may profit from the educational expenditures of another through the migration of population. The migration of population in the United States from one community to another is very great, and the communities in which the migrants spend a large part of their adult life are clearly in debt to the communities that provided the schooling for them in childhood.

The migration of adults of working age is not always regarded as a gain to the community to which they go. California did not welcome the "Okies" in the middle 'thirties. On the contrary, State officials endeavored to turn them back at the border. In the long run, however, the State will probably gain, just as the whole country benefited from the European migration of earlier years. It is estimated that the migration to California in the 'twenties exceeded that of the 'thirties, and the State did not protest.[29] And today California has found employment for most of the able-bodied survivors of the depression migration, and is apparently glad to have them. They would be even more of an asset, however, if they had been educated in a school system with standards as high as California's, and if they had not been underfed in their childhood.

The migration of the Negro northward offers similar advantages and disadvantages. Even if the States to which they go do not welcome them they must accept them, unless we are to add State immigration barriers to State trade barriers. And as long as the States permit them to come they have a stake in the educational, health, and relief standards of the communities in which the migrants spend their childhood.

B. Migration of Wealth and Industry To Escape Taxation [30]

1. INTRODUCTION

A feature of American taxation that has caused very wide discussion is that of migration of tax bases. Freedom of movement, both for the individual and for industry and trade, is one of the basic objectives of our Federal system. Trade barriers and resistance to personal migration do occur, but a very high degree of mobility of wealth and population has been maintained, and this mobility has been facilitated by modern improvements in communication and travel.

Free migration of industry is socially and economically desirable; but when the tax system or other fiscal measures are deliberately used to attract industries and taxable wealth from other taxing jurisdictions, serious questions of intergovernmental fiscal relations arise. The problem of induced migration crosses many other fields and concerns interstate more than Federal-State relations. But the latter are affected in so many ways that considerable attention to the problem is justified here.

2. FORMS AND EXTENT OF INDUCEMENTS OFFERED TO INDUSTRY

Probably the most prevalent forms of special inducement to industries are exemption from the local property tax and favorable State tax policies. Property-tax exemptions have increased greatly in recent years. In addition, States have given much attention to the possibilities of attracting or discouraging industry through State tax policy. They may not adopt tariffs in order to preserve the home market for their own producers, but they may offer special favors to industry as an inducement for its location or expansion. Tax concessions are only one among the many inducements offered to

[29] Select Committee To Investigate Migration of Destitute Citizens, Report on H. R. 369, 77th Cong., 1st sess., p. 8.

[30] Based in part on a monograph prepared for this study: William B. Gates, Jr., State and Local Advertising, Tax Exemption, and Subsidy of Industry.

industry by cities and States. The others include cash bonuses, loans, donations of site and building or their provision at nominal rental, guaranties of favorable labor conditions, and so on. Sometimes these inducements are offered by municipal governments without legal authorization, which renders the municipal officials personally liable for misappropriation of funds, but usually no great hazard is involved if the action has strong sanction from local public opinion. State and local advertising for new industries is widely practiced and a growing phenomenon.[31]

Although the States generally play a role secondary to localities in competitive bidding for industry, their activities are particularly important in setting the tone and providing the legal limits for municipal action. And of course the State tax system is itself a factor in interstate competition.

Legislation providing for exemptions is of three sorts: Laws allowing municipalities to exempt certain industries with the approval of the local electorate, legislation making such exemption mandatory, and statutes permitting cities to borrow money to buy or construct plants for new industries. Most of this legislation is found in the South and in New England. All of that in the North seems to be of the first type; that in the South is more frequently of the second and third types.

Mandatory exemption of new enterprise, provided by States, ranges from favorable classification of manufacturing machinery and other personal property of manufacturing concerns in certain Middle Atlantic and Eastern States, to extensive programs of exemption from all taxation in Florida, Arkansas, Mississippi, and Louisiana. There seems to be a trend toward the spread of such practices to the Midwest. Mississippi for a period sanctioned public borrowing and the expenditure of public money to buy or build industrial plants to be leased to private industries on terms approved by the State Industrial Commission and "in accord with the public welfare." This law was sustained by the Supreme Court of Mississippi,[32] and the United States Supreme Court refused to interfere in the matter, but it has been allowed to lapse.[33]

The major role in bidding for industry is played by municipalities, spurred on and, in many cases, led and surpassed by private business organizations, such as chambers of commerce.

Studies of the situation in Tennessee, Mississippi, and New England[34] show how extensive such activities have become in these areas, and provide evidence of the sectional nature of the problem. Tax exemption, money gift, building gift, land gift, free utility services, gift of moving expenses, advertising—all are relied on by cities and

[31] Virginia Lanahan, Advertising by the States, Council of State Governments, Chicago, 1940; Tax Administrators News, August 1941, p. 88. In 1933, only 6 States, Arizona, Florida, Maine, Michigan, Vermont, and Wyoming, were appropriating State funds for advertising purposes. By the end of the 1939 legislative session the total had grown to 40, with all the other States making some provision for the distribution of information concerning their special advantages.

The advertising was aimed chiefly at the attraction of industry, of agriculture, and of tourists. Advertising for new industries was heavily stressed in the southern and east-coast areas with definite indications of its spread to some of the Midwestern States.

[32] Session Laws of Mississippi, special session, 1936, ch. 1; *Albritton* v. *City of Winona* (181 Mississippi 75 (1938)).

[33] Tax Administrators News, vol. 4, No. 7, July 1940, p. 54.

[34] D. W. Knepper, "The Mississippi Industrial Program," National Municipal Review, vol. 27, No. 4, April 1938; Asa S. Knowles, "The Small City and Town Become Industry Conscious," The American City, January 1938, pp. 49-51, February 1938, pp. 71-75; Robert E. Lowry, "Municipal Subsidies to Industries in Tennessee," The Southern Economic Journal, January 1941, pp. 317-329; Dale Kramer, "Want a Factory?" Survey Graphic, August 1940, pp. 438-441.

towns to attract industry. Small nonindustrialized cities of under 10,000 population, offering additional incentives of low rent and cheap labor, are the chief but by no means the only offenders.

A few industries are getting the bulk of the subsidy encouragement. Particularly prominent are the shoe, garment, and textile industries; all of which have shown a tendency to move south. Mobility, small size of firm, small initial capital requirements, and an orientation toward small-town low rent and cheap labor characterize these industries.

Present locational trends may be summed up as follows: In all sections except New England there is a diffusion movement away from the center of cities toward the periphery and suburban areas. In only two major sections is there a marked dispersion of industry to small towns—the South Atlantic and East South Central sections. These are the sections in which subsidy practices are most prevalent.

What little data there are would support the statement that the war program has spurred municipalities to even greater efforts. No longer is it necessary to scour the country for drifting firms; they are to be had in one place—Washington.

Consideration for the interests of industry in the formulation of State tax programs—a subtle form of inducement—is quite general. The authors know of no debate concerning the inauguration or intensification of State income taxation in which the migration issue has not played an important part. Migration of individuals as well as industries is not unknown and figures considerably in the determination of State net-income tax and inheritance-tax policy.

A perusal of economic history will convince the student that special territorial inducements to industry are by no means a new problem. In fact, this instrument of territorial competition was quite widespread during the colonial era. In 1787 a cotton factory at Beverly, Mass., was not only exempted from taxation, but subsidized by the legislature until annual losses finally drove it out of business.[35] In 1805 cotton milling was completely exempted from taxation in New Hampshire and Vermont.[36] And so on. The general property tax and the uniformity clauses in State constitutions, developing after this era, were to some extent a reaction against these early favors. But even under the general property tax many special inducements continued. Pennsylvania manufacturing concerns were exempt from all State taxation until the recent introduction of the corporate income tax. The problem was much intensified as a result of the depression of the 1930's.

3. MOTIVES FOR TAX EXEMPTION FOR INDUSTRY [37]

The motive behind tax exemption and other special inducements to industry may be negative or positive. The negative motive may appear in a small city with an industrial population that has been left in desperate straits by the removal of an important factory. Without the factory in operation, the city is badly demoralized. Hundreds or thousands of workmen seek private or public relief; the real-estate market collapses as people leave town or lose their

[35] Caroline F. Ware, Early New England Cotton Manufacture, New York, 1931, p. 20.
[36] Jens P. Jensen, Tax Exemption as a Means of Encouragement to Industry, Kansas Studies in Business, May 1929, pp. 14-15.
[37] This section is based on Harold M. Groves, Financing Government, 1939, ch. XXI.

homes; the tax rolls suffer from delinquency, and so on. In such circumstances, a subsidy—whether legal or not—that would bring in an industry or keep the present one operating, would be likely to appeal to the city council as a good investment of public money. The threatened removal of a key industrial enterprise tends to extract generous concessions from the city fathers, who often have the approval of a large part of the electorate for their policy.

The positive motives are more complex. A community may wish to have new industries as a matter of pride, or as a matter of improving local business and real-estate values, or of increasing the local tax base, or of improving the balance between rural and urban population and offering more diversified employment opportunities to the people. In the South, particularly, the earnings of agriculture have been so low that almost any opportunity for industrial employment, even at low wages, seems an important advantage. Here is a case where the arguments for the protective tariff, particularly the infant-industries argument, are applied on a small scale.

The Supreme Court, in one famous case,[38] decided that certain direct subsidies for industry involved expenditure of money for a private purpose and were therefore illegal. As a matter of fact, in some industrial cities the retention of the local factory may seem a public purpose of the first order.

4. EFFECTIVENESS AND IMPORTANCE OF INDUCEMENTS

Many industries are located fairly definitely by relatively fixed factors; they are tied to their locations by such factors as the availability of natural resources, transportation facilities, and the market for their products. Others, as previously indicated, are not so securely tied and tend to a location because of rent and labor costs.

Attention should be called to the fact that actual migration of existing establishments is only one, and probably a minor one, of the ways in which industrial development takes place. Differential expansion also occurs through the birth of new industries and the establishment of branch plants by old enterprises.

The consensus of most of the studies concerning the effectiveness of governmental favors in the development of industry is that tax-subsidy considerations play a very small role in such development. Although it would be quite possible to overemphasize the importance of the problem, it seems very probable that most of the studies have leaned too far the other way. Some of them have approached the problem by an analysis of over-all relative industrial development and relative tax burdens.[39] These studies have shown that it cannot be demonstrated statistically or otherwise that the income tax within present limits has been prejudicial to the industrial growth of the States which have employed it. The studies have been inconclusive, but they have at least suggested that the income-tax States have achieved their fair share of the country's wealth and industry. They have been useful in showing that "progressive legislation" creates no immediate

[38] *Citizens Savings and Loan Association* v. *Topeka* (20 Wall. 655 (1874)).

[39] George L. Leffler and Harold M. Groves, Wisconsin Industry and the Wisconsin Tax System, 1930, Wisconsin Bureau of Business and Economic Research, Bulletin No. 1; Frank A. Hanna, Wisconsin During the Depression, 1936, Wisconsin Bureau of Business and Economic Research, Bulletin No. 5; George A. Steiner, The Tax System and Industrial Development, 1938, Bureau of Business Research, University of Illinois, vol. XXXV, No. 58; James W. Martin, The Possibilities of Income Taxes as Sources of State and Local Revenue, Lexington, 1932.

and dire locational reactions, and thus in allaying a chronic condition of bad nerves and public fear. But they tell us little or nothing about the effect that subsidy and tax exemption are having in attracting industry. Besides being based on a series of averaging processes, and utterly ignoring differences in the cost structures of different industries, they have applied mostly to Midwestern and Eastern States, where the problem is least severe.

On somewhat the same order are the studies made of reasons given by industrialists for initial establishment or for relocation.[40] These studies have usually found that taxation and other inducements are a relatively minor consideration in the minds of businessmen deliberating alternative location. This type of research also gives insufficient attention to the importance of government-created incentives in certain lines of enterprise in certain places.

A better approach is through an examination of costs with a breakdown by industries. Mobility in certain industrial lines is shown by these studies, and a proper analysis of what a subsidy might do at the margin is made possible. Unfortunately these studies are very rare indeed, a fact that suggests important possibilities for research. One of the few inductive treatments of cost material which has come to the authors' attention is that made of the metal manufacturing industry in Wisconsin,[41] a study which showed that State and local taxes amounted to only 1.65 percent of the cost of manufacture of these companies in 1927. This tax cost is very small compared with an item like wages. On the other hand, the balance of advantages between two locations may be close enough for a substantial subsidy to be the deciding factor. At least there are many members of city councils who think so. Where the bidding is for highly mobile plants, and other factors work in favor of relocation, the subsidy factor may play a substantial role at the margin. In New England, and even more in the South, the exemption-subsidy factor supplements other factors working in the same direction, and undoubtedly plays a substantial role in many cases, particularly where the choice is between a number of communities in a generally satisfactory area. The postwar period may see an intensification of the problem in those areas, and perhaps its spread to other areas, very possibly to the Midwest, where the break with the universal property tax tradition has already begun.

The English experience serves to substantiate this judgment.[42] The evidence concerning this experience shows that, although the derating of industry went far to eliminate differential burdens, localities have found other ways to attract industry.

The literature concerning special inducements in the United States contains examples of enthusiastic reports by cities and States on their exemption, and especially their advertising, programs, It would be impossible, in all specific instances, to advise a locality or a State against subsidy and exemption practices. There are too many other towns and States doing it, and too many seem, at least temporarily, successful. Nevertheless there are many cases of clear failure. Conspicuous in this latter class is Warsaw, Ill.[43] which, over the past

[40] Civic Development Committee of the National Electric Light Association and the Policy Holders Service Bureau of the Metropolitan Life Insurance Co., Industrial Development in the United States and Canada, 1926 and 1927.

[41] Edgar H. Auerswald, The Importance of Taxes to Wisconsin Metal Manufacturing Corporations, 1929, unpublished manuscript.

[42] Political and Economic Planning, Report on the Location of Industry, London, 1939.

[43] Dale Kramer, "Want a Factory?," Survey Graphic, August 1940, pp. 438-441.

15 years, has raised $83,000 and distributed it among successive manufacturers who promised to establish prosperous factories in the community. The establishments, including the one located there in 1940, paid out $370,000 in wages. Three out of five of them have failed in spite of subsidy assistance. The firms consisted of a shoe factory, two clothing-manufacturing companies, a leather-goods concern, and a battery plant. In 1940 Warsaw was looking for a concern to use the old clothing factory. A program of this sort, once embarked upon, is difficult from which to withdraw.

The movement has been growing and is quite likely to continue to grow in the post-war era. Surveying the record and the literature, the most conservative conclusion possible is that the migration-subsidy problem is potentially a very serious one.

5. CONSIDERATIONS OF STATE AND MUNICIPAL POLICY IN GRANTING TAX EXEMPTIONS OR OTHER INDUCEMENTS TO INDUSTRY

Is it sound policy for States and municipalities from the point of view of their own welfare to grant tax exemptions and other inducements to industry? Certainly something will depend upon the universality of such practices. If one merchant keeps his store open on Sundays while others are closed, he can make money by so doing. But if all merchants follow the same policy, none of them is benefited. Similarly, if only one municipality were to offer special favors, perhaps it could attract a considerable number of desirable industries. But when favors are universalized, they cease to be effective. The question then arises as to when and where the competition in subsidies will stop.

Whether or not it is sound policy for a municipality to offer special inducements to industry may also depend to some extent upon the suitability and general desirability of the industry. It would be a losing game for North Dakota to encourage a heavy manufacturing industry. The infant-industry argument usually accepts the proposition that eventually industry will be able to stand entirely on its own feet, and pay both satisfactory wages and taxes. Industry will never become self-supporting unless it is reasonably well suited to its environment. Some "hobo" firms have made a racket out of municipal inducements. Advantages granted to such concerns are likely to prove one-sided arrangements, with the municipality getting the worst of it.

Tax concessions and other inducements are at the expense of the taxpayers who do not receive them. The home owner, the wage earner, the merchant, the professional man, and, to a lesser extent, the farmer, are the ones who pay the subsidy. To be sure, these other taxpayers may stand to gain in the long run by the industrial development which the inducements seek to bolster. But the risk of the program is borne by these groups. New industries bring new expenses as well as new resources. The rise of industry in a given locality is not usually associated with a fall in tax rate.

From the social point of view it can be categorically stated that concessions and other inducements extended to industry by specific municipalities and States are highly undesirable. Concessions and inducements might conceivably be supported by the infant-industry argument. But industry appears to have had no trouble getting started in new territory in this country where conditions were favorable to its growth. Exemption tends to provoke retaliation and further exemption in an unending cycle. Migration of industry is likely to leave much human disaster in its wake because in many cases labor cannot follow the factory. The trend toward the organization of strong producers' groups is always a danger to governments. With States and municipalities serving as extensions to producers' groups and engaged in constant dickering with industrial interests, the danger of corruption in local and even State governments is considerably increased. Exemptions to particular property owners are demoralizing to those who continue to pay taxes. Tax exemption means a subsidy paid by the entire community, and it is very doubtful if all taxpayers have an equal stake in the benefits. By and large it would seem reasonable to conclude that natural rather than artificial advantages should be the determinants in locating industries

6. RELATION OF MIGRATION AND INDUCEMENTS TO THE OVER-ALL TAX PROBLEM AND INTERGOVERNMENTAL RELATIONS

Interstate competition in taxation is a factor of considerable importance to be reckoned with in sizing up the over-all tax system and intergovernmental relations. One aspect of the problem is that of building adequate and equitable tax systems in this highly competitive environment. Considerations of fairness to interstate business are also involved. Equity in taxation within the boundaries of a particular State may call for one solution of the tax problem, and considerations of interstate competition for another. For example, many States exempt personal property stored in commercial storage warehouses from the property tax. This form of property is of the first order of fluidity, and to apply the property tax to the contents of a warehouse on a specific date would very likely result in emptying the warehouse. But on considerations of equity alone, this property is entitled to no concessions in property taxation. This is but one illustration of the fact that State tax systems tend to treat migratory wealth and income with special favor.

Interstate competition creates special difficulty in the application of the income and inheritance taxes at the State level, and makes these taxes virtually unavailable at the local level. As previously stated, one of the main arguments with which proponents of State income taxes have always been confronted is that this type of taxation drives industry and wealth from the State that employs it, and thus tends to destroy not only its own base but that of the property tax as well. It is a well-known fact that interstate boundary lines impose limits upon State control of industry. This is one reason why the Federal Government is pressed to widen its field of activities. Even where State control and State taxation might in the long run prove beneficial to industry and wealth itself, the fear of "killing the goose that lays the golden egg," or in this case the fear of causing the goose to fly to some more congenial climate, is likely to be an effective barrier to social legislation and taxation. Industry is constantly moving about for a variety of reasons, and it is a simple matter to make it appear that firms are adjusting themselves to relative tax or other government-imposed burdens.

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Actually the income tax may not be so bad a developmental tax policy as is often contended. It imposes relatively light burdens upon infant industries—those which are building up and which have not yet been able to show a large net income. Deductibility of income taxes in computing State and Federal taxes greatly reduces income-tax differentials, a factor which is of great importance but which has received little attention. As previously stated, it has never been demonstrated that the industrial development of the income-tax States has actually suffered as a result of their tax programs. Legislative bodies in many cases have displayed considerable sales resistance when confronted with the urge to sell State concessions to the highest bidder or defer to considerations of interstate competition in selecting and applying their tax system.

In terms of Federal policy, programs to reduce the pressure of interstate competition upon State and local tax systems might and to a certain extent have been developed. The estate-tax credit was adopted and has been defended very largely as a means to this end in the death-tax field. The effect of the credit is to deprive a State which has no death tax of any advantage on this score since there is no corresponding reduction in the taxes paid by its residents. The Federal Government has, by means of the credit, to a large extent equalized death-tax burdens among States with and without a death tax. The same device has been effectively applied to pay-roll taxes earmarked for unemployment compensation. In the case of the income tax, Federal provision for the deductibility of the State tax in calculating the Federal tax provides a partial State-tax credit. It is far more effective as an antimigration measure than has usually been recognized. Federal taxes are less in States that have their own State income taxes. The proposal that a credit similar to that applied in the death-tax field be also applied to State income taxes has much to recommend it. However, it would be difficult to secure passage of such a measure because a third of the States have no income taxes, and some of them would have to amend their constitutions before an income tax would be acceptable to their courts. These States would probably oppose such legislation. More important still is the fact that accepting payment of Federal taxes in State tax receipts would involve a loss of revenue that the Federal Government can at present ill afford. Many feel that the States should not be encouraged to invade a tax field already well exploited by the Federal Government. Nevertheless, it seems doubtful that the States should be condemned to rely solely on regressive taxes to "tap their own resources." It seems more reasonable to conclude that the Federal Government should give all the encouragement that is practicable to support the States that are developing even a very limited progressive element in State tax systems.

Of course, the problem of interstate competition in relation to State tax systems is by no means confined to State income and inheritance taxes. For instance, considerable rivalry exists among certain States in attracting corporations to incorporate under their laws. Here the concessions are in leniency of regulation rather than in taxation, but they offer a good illustration of the possible advantages a State may reap by "proper" legislation. The use by Delaware of lax corporation laws to build up an "incorporation business" is notorious. The policy is a fiscal success, however, and brings into the State's treasury large sums each year in incorporation fees and franchise taxes. One writer suggests that the other States could afford to pay Delaware the cost of running its government if it would go out of the incorporation business.[44] He recalls in this connection that the Insull Middle West Utilities and Krueger International Match Co. were both incorporated in Delaware and concludes that while the conduct of these companies and their calamitous collapse cannot be ascribed entirely to the absence of any effective regulation by the State of their incorporation, this laxity was undoubtedly a contributing factor.

Governmental concessions to industry at the municipal level present a difficult problem for the Federal Government in distributing special aids to care for war-created local public expenditures. An examination of city applications for aid revealed a number of communities whose difficulties were in part due to the fact that they had frozen their tax system with legal restrictions. There is some indication that this was the case with Pascagoula in Mississippi, Tullahoma in Tennessee, and with Leesville and De Ridder in Louisiana.[45] The difficulty seemed to be in the exemption of both industries and new homes, which greatly increased the helplessness of the towns in handling a large influx of new industries and population.[46]

7. WHAT CAN BE DONE ABOUT THE MIGRATION PROBLEM

Several ways in which tax policy can be shaped to take account of the migration problem have been suggested. They may be summarized as follows:

1. The States' difficulties in this matter justify or support an enlargement of the Federal tax system and perhaps an expansion of the Federal Government on its functional side.
2. The Federal Government through its deductibility and crediting devices can protect the States which tax migratory tax bases.
3. The States can be urged to respect the fact that the "bark" of threatened migration is often more vicious than its "bite."
4. Municipalities can be urged to consider both sides of the balance sheet and to weigh factors of suitability before they offer concessions to new industries.

Beyond these recommendations the Federal Government, in cooperation with the States, might set up some agency to hear complaints and publicize findings concerning unfair competition among municipalities. Special concessions to industry have much in common with trade barriers, and the same agency might serve as to both sources of complaint. This proposal will be discussed further in connection with trade barriers. At the Federal and interstate level a broad educational program might produce salutary results. This type of attack has had some success, apparently, in stemming the advancing tide of trade barriers. The States and municipalities should be kept

[44] John T. Flynn, "Why Corporations Leave Home," Atlantic Monthly, September 1932, pp. 268–276.

[45] Defense Public Works, Docket No. Mississippi 22–106, Tennessee 40–104, Louisiana 16–101.

[46] The case of Pascagoula is particularly interesting. The Ingalls Shipbuilding Corporation was established at Pascagoula under the Mississippi Industrial Act. Jackson County furnished all land upon which the yard is located and floated a $100,000 bond issue to carry out all necessary dredging and other work. The firm was exempted from taxes for 5 years. War orders have greatly expanded activities at the yard and increased the community's population by almost 50 percent.

up to date on migrational trends, and on the kinds of industries involved and their characteristics. As has already been suggested, research in the field of migration to avoid taxes has been insufficiently directed toward the importance of taxes as an element in the costs of specific industries and of differential tax costs as an incentive for location or relocation. Further study along the lines suggested can be recommended, and this might be undertaken or stimulated by a Federal-State Fiscal Authority. Federal incorporation of concerns engaged in interstate commerce has been previously discussed and recommended.

At the State level, effective State supervision of local property-tax administration is a desirable antidote to illegal property-tax concessions by municipalities. Such supervision is very unusual among the States. If a State is thoroughly committed to industrial promotion, a coordinator of industrial activity development might help to direct the movement along intelligent lines. He could seek to eliminate internal competitive bidding and to assure that "proper" industries are attracted from the outside. Just how much interstate cooperation or reciprocal legislation might accomplish in this field is difficult to predict, but some good could hardly fail to result from even an effort to apply these instrumentalities to the problem.

It remains true, however, that territorial competition constitutes a large and growing factor in the development of a sound tax system and in intergovernmental relations, and a factor that is singularly difficult to diagnose and counteract.

C. Multiple Taxation

1. INTRODUCTION

A principal problem of interstate relations is that of territorial multiple taxation and here, as in the case of migration, there are many repercussions in the field of Federal-State relations. "Today virtually every tax form, whether it is related to property, sales, gross income, net income, capital stock, or other transactions employing monetary or physical units, deals with interstate activities." [47] There are many cases in which the same base is taxed by two different jurisdictions where it would have been taxed only once and much less if the base had been exclusively in one State. This operates as a first-rate trade barrier and is generally (and properly) regarded as an unmixed evil. Unfortunately, little has been done to eliminate the evil and it is astonishing but true that little or no attempt, to the authors' knowledge, has ever been made to measure its extent.

It is not true, as sometimes inferred, that tax assessors are the only ones who can take advantage of jurisdictional complications to make unreal allocations of the tax base. Taxpayers may profit as well as lose by the confusion. Unfortunately, the two types of errors are not compensating in most instances for the reason that they are not both applicable to the same taxpayer. They must be added together in summing the inequities.

Some protection against multiple taxation is afforded by the courts. The fourteenth amendment is applied to invalidate a tax levied on a base beyond the jurisdiction of the taxing authority. But what does, and does not, lie within a given jurisdiction is often not subject to a

[47] George Mitchell, unpublished manuscript.

definite ruling by courts. Moreover, in a very recent decision [48] the United States Supreme Court took a long step away from judicial responsibility for the elimination of multiple taxation.

2. JURISDICTION TO TAX AS DEFINED BY THE JUDICIARY [49]

(*a*) *Property taxation.*

Until quite recently, at least, the boundaries of judicial tolerance in jurisdiction to tax were fairly definite as applied to property taxation. As a rule, tangible property is taxable only where located or customarily kept.[50] Intangible property is taxable mainly at the domicile of the owner. However, intangible property is said to have a business situs which makes it taxable in the State in which it is regularly employed in a business.[51] Debts secured by property are not taxable in the State where the supporting property has its situs, though it has been held that a nonresident mortgagee can be required to pay taxes on his interest in local real estate.[52]

For railroads and public utilities extending beyond State boundary lines, some apportionment is required. The use of track mileage as the sole basis of apportionment was declared contrary to the fourteenth amendment in the North Dakota case of *Wallace* v. *Hines*.[53] The single standard was said to take no account of density of traffic and the location of terminal property. States have thus been constrained to use a basis of apportionment that gives weight to more than one factor. However, as later explained, the courts have proved an inadequate defense against "importation" of value.

(*b*) *Death taxation.*

In general, jurisdiction for the State death taxes has followed the rules for property taxation stated above. (Recent decisions of the Supreme Court have made it necessary to use the past tense in speaking of jurisdictional rules in this field.) In the case of intangibles left by a decedent, the State of the decedent's domicile has had the legal right-of-way in all but a few exceptional cases.

The problem of multiple taxation in the death-tax field is complicated by the plausible claims of competing jurisdictions. There is the claim, for instance, of the jurisdiction in which the heir as distinguished from the deceased, is domiciled. The claim appears to rest on strong grounds for the ability to pay is as much the heir's as the decedent's. However, nowhere in this country and rarely abroad, has the State of the heir's domicile asserted any claim under the estate tax. The estate is administered in the State where the decedent is domiciled, and this State has been assumed to have exclusive rights, so far as such rights are based on domicile. Unincorporated real property is taxable where located. The State in which is situated incorporated real property, of which the absentee decedent's shares are representative, also has some logical claim to

[48] *State Tax Commissioner of Utah* v. *Harkness* (10 U. S. Law Week, 4341-4347, Apr. 28, 1942).
[49] Based in part on H. M. Groves, Financing Government, chs. X and XIX.
[50] *Union Refrigerator Transit Co.* v. *Kentucky* (199 U. S. 194 (1905)); *Delaware, L. & W. Railroad Co.* v. *Pennsylvania* (198 U. S. 341 (1905)); *Frick* v. *Pennsylvania* (268 U. S. 473 (1925)).
[51] *Metropolitan Life Insurance Co.* v. *New Orleans* (205 U. S. 395 (1907)).
[52] *Savings and Loan Society* v. *Multnomah Co.* (169 U. S. 421 (1898)).
[53] 253 U. S. 66 (1920).

impose a death tax. Formerly such claims were freely asserted but they have now been quite thoroughly outlawed.[54] Judicial opinion on this matter was not unanimous; in a Wisconsin case [55] a minority opinion held that the corporation might, through its relationship as agent for its stockholders, bring the latter under the jurisdiction of the States in which the corporation did business. The dissent also laid stress on the fact that the corporation is only a legal fiction and that the stockholders could acquire a right to physical property by merely dissolving the corporation.

A strong claim on legal grounds can be asserted by the State in which the corporation, whose shares are involved in the transfer at death, obtained its charter. Until a few years ago it was quite common for the State of incorporation to tax nonresidents upon the full value of their shares in the corporation. In the important *First National Bank of Boston* v. *Maine* decision,[56] the Supreme Court ruled out all rights of the States to tax on the ground that they incorporated the company in which the decedent had shares. Such taxation was held to be contrary to the fourteenth amendment of the Federal Constitution under which the States may not deprive one of property without due process of law. A strong minority opinion held that the fourteenth amendment was being stretched beyond its legitimate application. Moreover, there were the interests of the debtor States to be considered. In a recent case, discussed below, the Boston bank decision was overruled.

Multiple taxation in the death-tax field also arises in cases of disputed domicile. This was brought sharply to the attention of the country in the notorious Dorrance case,[57] where both Pennsylvania and New Jersey, in addition to the Federal Government, succeeded in taxing the same intangible assets. The main element in establishing domicile is intent, and intent may be proved or disproved by a wide range of evidence, concerning the balance of which reasonable men and reasonable courts may differ. It seems logical, in cases of disputed domicile, to seek the arbitration of the United States Supreme Court, but the Court has rejected this role and has held that—

> uniformity in the decisions of the courts of different States as to the places of domicile, where the exertion of State power is dependent upon domicile within its boundaries—

is not required by ~~the~~ Constitution.[58] Efforts to implement the Supreme Court with the power to settle disputes of this character have proved abortive, and a move to induce States to adopt legislation referring disputed domicile cases to arbitration has as yet achieved no success.[59] It is very probable that double domicile cases, while conspicuous, and usually involving large estates, are quite rare, and the problem may have attracted more attention than it deserves. But no fair-minded individual can sanction this form of multiple taxation and it is quite clear that something should be done about the matter.

Great interest in jurisdiction to tax in the death-tax field attaches to the recent decision of the United States Supreme Court, overruling

[54] *Beidler* v. *South Carolina Tax Commission* (282 U. S. 1 (1930)).
[55] *Estate of Sheppard* (184 Wis. 88 (1924)).
[56] 284 U. S. 312 (1932).
[57] *Dorrance's Estate* (309 Pa. 151 (1932)), *In re Dorrance* (115 N. J. Eq. 268 (1934)); *Dorrance* v. *Pennsylvania* (287 U. S. 660 (1932)).
[58] *Worcester County Trust Co.* v. *Riley* (302 U. S. 292 (1937)).
[59] Bills embodying this plan have been introduced in the Delaware and New York legislatures. Bulletin of the National Tax Association, April 1941, p. 210.

the Boston bank decision and upholding the right of Utah to tax the Union Pacific Co. stock of a nonresident decedent on the ground that the corporation had been given its charter by the taxing State.[60] This is an epoch-making decision and the divided opinions of the Justices contain so much illuminating discussion of the multiple-taxation problem that they are quoted here at considerable length.

Justice Douglas, speaking for the Court, stated that it was not unmindful of the view that judicial license for multiple taxation—

> disturbed the "good relations among the States" and had a "bad" practical effect which led many States "to avoid the evil by resort to reciprocal laws."

But in support of the determination to overrule the Boston Bank case he quoted the minority opinion in that case as follows:

> "We can have no assurance that the resort to the fourteenth amendment, as the ill-adapted instrument of such reform, will not create more difficulties and injustices than it will remove."

And he added:

> More basically, even though we believed that a different system should be designed to protect against multiple taxation, it is not our province to provide it.

In a concurring opinion Justice Frankfurter expressed the view that—

> each State of the Union has the same taxing power as an independent government, except insofar as that power has been curtailed by the Federal Constitution.

The limitations on State taxing power in the Constitution, dealing with the taxation of imports and exports, tonnage taxes, and discriminatory taxes on interstate commerce were reviewed, and it was concluded that—

> none of these limitations touches the power of a State to create corporations and the incidental power to tax opportunities which such State-created corporations afford.

To be sure—

> A State cannot tax a stranger for something it has not given him. When a State gives nothing in return for exacting a tax it may be said that there is no jurisdiction to tax.

But—

> modern enterprise often brings different parts of an organic commercial transaction within the taxing power of more than one State, as well as of the Nation. It does so because the transaction in its entirety may receive the benefits of more than one government. And the exercise by the States of their constitutional power to tax may undoubtedly produce difficult political and fiscal problems. But they are inherent in the nature of our federalism and are part of its price. These difficulties are not peculiar to us. Kindred problems have troubled other constitutional federalisms. * * *
>
> It may well be that the last word has not been said by the various devices now available through uniform and reciprocal legislation, through action by the States under the compact clause, article 1, section 10 (3), or through whatever other means statesmen may devise for distributing wisely the total national income for governmental purposes as between the States and the Nation.

In his dissenting opinion, Justice Jackson (Justice Roberts concurring) described the majority view as "a switch of abstract concepts" without adequate consideration of its "impact on the very practical and concrete problems of States and taxpayers." He added:

> The older view ascribed a fictional consequence to the domicile of a natural person; it is overruled by ascribing a fictional consequence to the domicile of an

[60] State Tax Commission of Utah v. Aldrich (10 U. S. Law Week, No. 42, [illegible]), Apr. 28, 1942.

artificial corporation. The reason back of the holding is this: Because Utah issued a charter to a corporation, which issued stock to a nonresident, which changed hands at his death, which required a transfer on the corporation's books, which transfer was permitted by Utah law, Utah got jurisdiction to tax succession to the stock. It is really as remote as that.

It appeared to Justice Jackson that any benefit derived by Union Pacific stockholders from Utah was negligible in proportion to the value Utah was being authorized to tax. Most of the value was derived from operation in interstate commerce—

a privilege which comes from the United States and one which Utah does not give or protect and could not deny.

The effect of the Court's decision, thought the Justice, would be—

to intensify the already unwholesome conflict and friction between the States of the Union in competitive exploitation of intangible property as a source of death duties.

Referring both to tax payment and tax-compliance burdens, he added:

The seriousness of these burdens is increased if the decedent owns stock in consolidated corporations incorporated in several States, and under this decision stocks of some consolidated railroads would be subject to tax on their full values by five or six States. One need not be unduly soft-hearted toward taxpayers to doubt whether the exhaustion of estates through multiplication of reports, returns, appraisals, litigation, counsel's fees, and expenses ultimately makes for a sound fiscal policy or enlightened social policy.

Justice Jackson referred to previous efforts at death-tax coordination as due to a—

premonition among the States that overlapping, capricious, and multiple taxation would lead to Federal occupation of the field.

He observed further that—

far-sighted States saw that the total revenue resources practically available to the States was not increased by overlapping their taxation and invading each other's domiciliary sources of taxation.

The Court's action, said Justice Jackson, leaves "doubts whether any legal limitations are hereafter to be recognized" in States' power to tax. The doctrine of benefit as a basis of taxation appeared to him impractical because in our interdependent society all States benefit all citizens. Expansion of the field of multiple taxation to other situations involving intangibles and possibly even tangibles seemed likely although the Justice trusted that the Court did not mean to say that "might always makes right in taxation" and he predicted that some new boundaries of the power to tax would have to be drawn.

One commentator anticipated this decision with the observation:

The Court will no longer act as arbiter of the conflicting claims of the several States as long as those claims are reasonable. * * * Legislatures must face some of the difficulties that the courts have long shouldered for them.[61]

(c) *Other taxes.*

The Supreme Court has never shown any inclination to do in the income-tax field what it once apparently set out to do in death taxation, that is, eliminate territorial multiple taxation. It is well established that income derived by a nonresident from a source within a State is taxable in that State.[62] On the other hand, it is also well

[61] Jesse V. Burkhead, "Double Taxation and Jurisdiction to Tax." Bulletin of the National Tax Association, vol. 25, No. 9, June 1940, pp. 259-266.

[62] *Shaffer* v. *Carter* (252 U. S. 37 (1920)).

established that all the income received by a resident taxpayer, regardless of its derivation, may be taxed by the State in which he resides.[63] It is clear that a State may not tax the interest and dividends *received* by a nonresident from a corporation within the State, but there is legal precedent sustaining a tax upon the dividends *paid out* by such corporation.[64] In the case of corporate income where the problem is one of apportionment, it is only in very clear and extreme cases that the courts have interfered with State discretion. It is not clear whether corporate income from intangibles may be taxed at the State of the corporation's domicile or that of its head office or both.[65]

A special and conspicuous form of "importation of value" occurs in the field of capital-stock taxation. It is apparently within a State's legal power to tax (at least under the franchise tax) all the securities issued by a corporation that it incorporates. As previously explained, this opens the way for both extraterritorial and multiple taxation, and certain States, of which Delaware is the most conspicuous example, have exploited this opportunity quite successfully. The latent possibilities of multiple taxation in the field of stock-transfer taxation are thus far largely undeveloped but they are quite substantial.

In insurance taxation the use of gross income (that from all investments) as the base of the tax on domestic companies in some States involves a unique kind of importation of value.

3. SPECIAL PROBLEMS OF MULTIPLE TAXATION

(*a*) *Property taxation.*

For many years railroads have contended that they are substantially overtaxed because States manipulate their tax laws and administration so as to reach more railroad property than that to which they are entitled. That there are cases of "exportation of value" is also recognized, cases where the taxpayer maneuvers, or circumstances conspire, to produce a result in which jurisdictional factors are so combined that less than the full base is taxed. A plausible case could be made on this ground for a Federal system of railroad assessment and apportionment, but such a development has never been seriously considered.[66]

Railroad allocation is undoubtedly a very difficult analytical problem, involving both the choice and the weighting of factors. The relative claims of the States in which traffic arises and those in which it terminates, and of the "bridge" States, are quite difficult to arbitrate. The futility of one approach to the problem has been described by Mr. George Mitchell, presently on the staff of and formerly member of the Illinois Tax Commission, as follows:

> The argument that a particular segment of a railroad system is indispensable to its existence and prosperity, can be applied to any segment and offers no more assistance to solving the problem of valuation than the schoolboy problem of how one would determine the contribution of the butter, bread, and ham to a ham sandwich. Lacking any of these elements, he would not have a ham sandwich.[67]

[63] *Maguire* v. *Trefry* (253 U. S. 12 (1920)).
[64] *State of Wisconsin* v. *J. C. Penney Co.* (311 U. S. 435 (1940)).
[65] *First Bank Stock Corp.* v. *Minnesota* (301 U. S. 234 (1937)).
[66] An interesting discussion of the use and misuse of apportionment factors can be found in Proceedings of the National Tax Association, 1937, pp. 251, 301.
[67] George Mitchell, unpublished manuscript.

Left to their own devices, the States are likely to evolve a combination of factors favorable to their own interests, a propensity well illustrated by the ingenious and unique factor in the Illinois apportionment, namely that of "traffic originating and terminating."

The case for Federal assessment and apportionment has been plausibly stated as follows: [68]

One making an impartial study of the evidence in these tax suits (State of Washington) cannot but be impressed with the desirability of some method being devised for the determination of the assessable value of interstate railroads by some national board clothed with the power not only of valuation of the railroad system as a unit, but the power and duty of apportioning such unit value among the interested States.

Note that each assessing board acts independently of similar boards of the other States transversed, and is ordinarily not even required to disclose to anyone the system value so found. * * * One may fix such value at $300,000,000, another at $275,000,000, another at $250,000,000, and so on, and yet each value so found might be sustainable under the wide discretion accorded the findings of assessing boards.

But this is by no means the worst feature. Having found such system value, each such assessing board determines for itself the percentage apportionable to the particular State. And here again, such assessing board is given tremendous leeway. The extent of such discretionary power is illustrated by the allocation factors proposed by the Northern Pacific in the suits just discussed. It proposed a straight average of five factors: (1) Relative car-miles; (2) relative ton- and passenger-miles; (3) relative gross revenues; (4) relative all-track miles; and (5) relative depreciated reproduction cost. Each of these factors has received judicial endorsement by one court or another. Now, in a State such as Washington where the traffic is light and the construction cost high, the ton-mile factor accords Washington 22 percent and the reproduction-cost factor 34 percent, or a spread of more than 50 percent. But in South Dakota, where the traffic is comparatively dense as a result of trans-State shipments of interstate freight in each direction, and the cost of construction over prairie country is comparatively low, the ton-mile factor is probably 50 percent higher than the reproduction-cost factor. Now, since each assessing board naturally seeks to obtain the full taxable value for its own State, it is tempted to choose a factor or combination of factors yielding its State the biggest percentage of system value sustainable by the courts. The result is that when the railroad whose property has been assessed adds all its State assessments together it may find that instead of being assessed in the aggregate of 100 percent of its system value, it has in fact been assessed on a basis of 125 percent, or even 150 percent of its system value.

Nor is there anything revolutionary in this idea of determination of tax value by a single Federal board. The Interstate Commerce Commission is clothed with the exclusive power of determining the value of interstate roads for both local and interstate rate-making purposes, a function no less important to the States than matters relating to taxation.

But could the Interstate Commerce Commission be clothed by Congress with the power to make assessments without constitutional amendment? The writer believes so. The courts have recognized the power of Congress under the commerce clause to limit and control State taxation of the subjects of interstate commerce. It would seem that for the same reason Congress would have the power to likewise limit and regulate State taxation of interstate instrumentalities such as railroads.

The authors do not share the confidence expressed above in the constitutionality of legislation granting exclusive power of assessment and apportionment of railroad property for tax purposes to the Federal Government. But some progress should be possible through the promotion of the use of a fair and balanced uniform apportionment formula.

[68] R. G. Sharpe, Report on the Railroad Tax Litigation, State of Washington, 1937, pp. 251, 301.

Mr. Mitchell suggests the following solution, which can be endorsed here:

> It would be an important contribution to advancing better fiscal relations between States if the problem of allocation were met by an interstate compact recognizing and recommending the use of four or five allocation factors giving consideration to the claims of both terminal and bridge States. This would insure that the entire property of interstate business were taxed in some State, would promote more reliance on measurable facts in determining full values, which is a necessary antecedent to allocation, and would insure fairer treatment to railroad companies. It might actually lead to general acceptance of uniform system values.

The application of the property tax to air-transportation companies is quite as troublesome though not as fully developed as in the case of railroads. On the precedent of decisions to the effect that vessels engaged in lake transportation are taxable at the home port, Minnesota has recently attempted to tax the entire fleet of the Northwest Air Lines. This attempt, if successful, would open up a very large new field of multiple taxation. Other States will hardly be bound by Minnesota's determination of situs for aircraft taxation. The Minnesota assessment has been sustained by a lower court and is now before the State supreme court.[69] On the analogy of railroad taxation, it would seem that the States are entitled to tax only an apportioned share of such companies' fleets. An air-transportation company is an excellent example of a case where State boundary lines mean very little indeed. Air lines are essentially interstate and of great Federal interest; the industry should not be subjected to the incubus of multiple taxation. It is hoped that the Minnesota court will hold that some system of apportionment, such as route miles, passenger miles flown, or revenue miles flown, is required. Even a decision of this character would leave possibilities enough for multiple taxation in the field of air transportation.

(*b*) *Death taxation.*

As previously described, before the Boston bank decision a well-organized campaign, led by a special Pennsylvania tax commission and supported by a group of State tax commissions, achieved considerable success in the promotion of reciprocal State death-tax legislation. The legislation provided that a State would not tax the intangibles of nonresidents domiciled in States that provided similar treatment for the residents of the former State. After the Boston bank decision, the movement subsided and some, though not all, of the reciprocity statutes were repealed. The problem of double domicile in death-tax cases has been a subject of much discussion during the last 7 years. A committee of the National Tax Association submitted five successive reports on the subject.[70] Hopes of arbitration by Federal courts in the absence of very special circumstances have been dashed by the Supreme Court.[71] The Tax Association's committee in its final report recommended mainly State reciprocal legislation under which States would consent to be sued in the determination of disputed domicile in the United States District Court of the District of Columbia.[72] The recommendation appears sound but needs some Federal pressure to hasten its general enactment.

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[69] *State of Minnesota, Respondent* v. *Northwest Airlines, Inc.*, Brief on behalf of appellant (1942).

[70] Report of the Committee of National Tax Association on Double Domicile in Inheritance Taxation, Farwell Knapp, chairman, Proceedings of the National Tax Association, 1935, pp. 201, 213. Subsequent reports, 1936, pp. 87, 98; 1937, pp. 453, 466; 1938, pp. 741, 759; 1940, pp. 232, 255.

[71] *Worcester County Trust Co.* v. *Riley et al.* (302 U. S. 292 (1937)).

[72] Final Report of National Tax Association Committee, op. cit., 1940.

(*c*) *Income taxation.*[73]

(1) *Situs versus residence.*—The refusal of the courts to intervene in the income-tax field leaves many opportunities for multiple taxation. The multiplicity results from the application of different jurisdictional rules by different States. Wisconsin taxes only income "earned within the State," by which is meant that the income from property or business follows the location of such property or business, and income from services and intangibles follows the domicile of the taxpayer. Some States, e. g., Delaware, tax entirely on the domicile principle, taxing all income of individuals domiciled within the State, regardless of where the income is earned. But many States, e. g., New York, tax residents on all their income, wherever earned, and, in addition, nonresidents on the income (including service income) earned within the State. New York also provides an arrangement under which it agrees to credit the tax paid by a nonresident to his own State against the New York tax, provided the other State reciprocates. Under these arrangements the possibilities of double taxation are apparent. One residing in Delaware and owning property in Wisconsin is taxed twice on the income of such property. On the other hand, in case the facts are reversed, the property owner escapes both taxes entirely.

(2) *Use of interstate credits.*—A number of States have attempted to solve one of the double taxation dilemmas in the personal income-tax field by the use of tax credits. Five States allow tax credits to nonresidents;[74] five more, to residents:[75] and six allow credits to both residents and nonresidents against the tax imposed by them on income taxable under their laws for taxes imposed by other States on the same income.[76] The credit to nonresidents is generally conditioned upon reciprocal grants by the State whose taxes are sought to be credited.[77]

The reciprocal tax credited to nonresidents has been employed by New York State from the inception of its law, and has been championed by E. R. A. Seligman.[78] In his view, the reciprocal tax credit is a temporary device designed to equalize interstate competition, pending the adoption of a personal income tax by every State. If New York did not tax its nonresident employees, the latter would possess a tax advantage over resident New Yorkers if their home States imposed no income tax; which is the case in the contiguous States of New Jersey and Connecticut, both of which constitute sizable residential districts for employees in metropolitan New York. Given universal adoption of net income taxes, the reciprocal tax credit would result in the universal adoption of the domicile principle for jurisdiction to tax. And the desirability of limiting the personal income tax to residents is widely accepted.[79]

On the other hand, Clarence Heer has written a strong defense of the unconditional credit to residents.[80] He points out that reciprocal

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[73] This section is based on a monograph prepared for this study: Herbert Klarman, Personal and Business Net Income Taxation in the States.

[74] Iowa, New York, North Carolina, South Carolina, and West Virginia.

[75] Colorado, Georgia, Kansas, Mississippi, and Vermont.

[76] Alabama, California, Kentucky, Maryland, New Mexico, and Virginia.

[77] Reciprocity also extends to the income of nonresidents, whose State of residence does not tax residents of this particular State, regardless of the reasons, e. g., failure to employ an income tax or taxing solely under the domiciliary principle.

[78] E. R. A. Seligman, "Taxation of Nonresidents in New York Income Tax," National Tax Association Bulletin, vol. 5, No. 2, November 1919, p. 40.

[79] Charles J. Bullock, chairman, "Second Report on a Plan of a Model System of State and Local Taxation," Proceedings of the National Tax Association, 1933.

[80] Clarence Heer, "Reciprocity—A Critical Appraisal of Its Possibilities," Proceedings of the National Tax Association, 1940, p. 350.

tax credits to nonresidents sacrifice the claims of situs to the claims of residence. The debtor States stand to lose.

On the other hand, neither the debtor nor the creditor State is at a disadvantage when it grants credits for out-of-State taxes to its own residents. In this case neither State surrenders any of the taxes which it collects from nonresidents on the basis of situs. The credits merely represent an internal readjustment of the State's tax burden.[81]

Furthermore, any State can give its own residents complete protection from double taxation by unilateral action. To extend similar protection, reciprocity requires universal adoption, an unlikely eventuality in view of the contrary interests of the debtor States.

If the ultimate aim is taxation on the basis of domicile only, reciprocal credits to nonresidents are clearly preferable to unconditional credits to residents, and are quite justified by the equalization of competition argument. Likewise, the ultimate character of the unconditional credit to residents is taxation according to situs, without, however, the customary concomitant of a divided ability to pay. A choice between the two types of credit can therefore be made on the basis of their ultimate implications and the significance one attaches to them.[82]

Just as the situs rule redounds to the advantage of the debtor States, the domicile rule favors the creditor States. Although efforts have been made [83] to establish the superiority of one rule or the other, it is exceedingly difficult to choose between them on any basis of inherent superiority. In this state of affairs, there is much to be said for a 50-50 rule, that is, an equal division between the State of domicile and that of situs.

State double taxation of income can be avoided either by resident credits or by nonresident credits. It is immaterial whether (1) the State of residence grant credits for taxes paid to other States (on income earned in those States), or (2) the State of nonresidence grants credits for taxes paid to the State of residence (on income earned in the nonresident State). If either method were uniformly adopted in all the States having income-tax laws, double taxation of income resulting from the taxation of residents on income from extraterritorial sources and of nonresidents on income from sources within the taxing State would be completely avoided. But so long as some States adopt one system and some the other, discriminatory multiple taxation of the

[81] Ibid., p. 355.

[82] However, one point requires clarification. It appears incorrect to say, as Clarence Heer says, that when a State grants a credit to residents, it "does not surrender anything to other States," (Heer, op. cit. p. 354) but merely allows an "internal readjustment of the State's tax burden." True, each State retains the taxes imposed on nonresidents; but it surrenders an indeterminate amount of taxes that would otherwise be collected from its residents, to the States in which the income originated. The debtor States can raise their rates to as high a level as they please, and thus deprive the creditor States of a large portion of the income-tax revenue from residents with interstate economic interests. The internal readjustment of the State tax burden may therefore be of considerable interest to its taxpayers. Since the taxpayer with interstate interests would pay his taxes to the State of origin, a State which suffers a net loss on the balance would be required to impose heavier burdens on purely local taxpayers in order to secure a given revenue yield. While there is no resulting discrimination in tax burden in favor of the interstate taxpayers (indeed, the local taxpayer's tax constitutes a minimum tax for the interstate taxpayer), a higher level of taxation in the given State than elsewhere does follow.

[83] The second committee on the model plan of the National Tax Association seeks to demonstrate that income taxation ought to proceed on the basis of domicile. The reasons are as follows:

(1) Ability to pay is measured by total income. To subdivide it is to grant a tax advantage to the taxpayer with interstate economic interests.

(2) A person's style of living is determined by his total income. The larger one's income, the greater the demands one makes for more expensive public services.

(3) By exempting income from out-of-State sources, the State puts a premium on the export of capital and creates a privileged class of investors on foreign account.

(4) Since investors on foreign account constitute a small portion of the voting population, it is not politic to tax them. If each State ought to levy upon the total income of its residents, taxation according to situs is out of the question, if discriminatory total taxation is to be avoided (Bullock, chairman, plan II, op. cit., pp. 368-370).

same income will exist.[84] For lack of agreement on one uniform credit, it would be better for each State to adopt both credits, and to use one or the other in appropriate relation to the tax behavior of the other State concerned.

A simple solution of the immediate problem of double taxation would be to allow residents as well as nonresidents a tax credit. The credit to residents should be confined to taxes imposed by other States which do not allow credit to nonresidents. This provision would save residents from double taxation and would also avoid the confusion implicit in a situation in which both the State of residence and the State of nonresidence offer a credit to a taxpayer.[85] Similarly, to save confusion, nonresidents should be denied credit for taxes imposed by their State of residence, in cases where the State of residence of the nonresident allows an unconditional credit to its residents. Nonresidents whose State of residence taxes income of residents from extraterritorial sources and also taxes the income of nonresidents from local sources, but fails to allow credit to either residents or nonresidents, would remain subject to double taxation.

(3) *Residence of individual.*—The overlapping of jurisdiction discussed above may result in evasion for some taxpayers as well as discriminatory tax burdens on others. However, even the exercise of uniform jurisdictional powers by every State does not insure against these evils, in the absence of uniform statutory or regulatory interpretation of the judicial jurisdictional grants. It is possible for an individual to pay taxes in two States, both taxing residents on all of their income, regardless of source,[86] because each adopts a different set of alternative definitions of residence. Discriminatory multiple taxation or evasion would result if each State confined itself to one interpretation of residence for tax purposes, so long as the States could not agree on one uniform interpretation; an alternative set of interpretations is even more likely to produce these evils, since they are especially designed to insure a maximum revenue flow to the State.

In a few States, the term "resident" includes only persons domiciled within the State.[87] While in most other States domiciliaries are included among residents,[88] the latter term extends also to other individuals. A resident may be one who maintains a permanent abode in the State,[89] maintains it for a specified period of time during the taxable year,[90] spends a specified portion of the taxable year in

[84] Thus, if some States allow residents a credit for taxes imposed by other States and some allow nonresidents a credit for taxes imposed by the State of residence, residents of the latter deriving income from sources within the former will not be entitled to credit in either State. Conversely, if some States allow residents a credit for taxes imposed by other States and some allow nonresidents a credit for taxes imposed by the State of residence, residents of the former deriving income from sources within the latter are in a position to evade taxes completely. This would happen if each State allowed a credit for taxes imposed by the other before any deduction for credit allowed by the other is made. In any case, a system of unconditional credits to residents or nonresidents by different States is indeterminate and cannot operate. (Frank M. Keesling, "The Problem of Residence in State Taxation of Income," California Law Review, vol 29, September 1941, pp. 711–712.)

[85] If the credit to residents is confined to taxes imposed by other States which do not allow credit to nonresidents, resident credit provisions would automatically become inoperative if all the States adopted nonresident credit provisions. (See Keesling, op. cit., p. 715.)

[86] In pursuance to the decisions in *Lawrence* v. *State Tax Commission* (286 U. S. 276 (1932)); *Cohn* v. *Graves* (300 U. S. 308 (1937)).

[87] Massachusetts and New Mexico; apparently, also New Hampshire.

[88] Idaho does not tax a domiciliary. Likewise, California does not tax a domiciliary, if he has a residence elsewhere. New York exempts domiciliaries who maintain no permanent place of abode in the State but maintain one elsewhere and who are not within the State for more than 30 days of the taxable year.

[89] Alabama, Arizona, California, Iowa, Louisiana, South Dakota, West Virginia, Wisconsin, Idaho, Mississippi, and Missouri. Minnesota treats an individual as a resident if he maintains a permanent abode in the State, while not domiciled elsewhere.

[90] Arkansas, Colorado, Georgia, Kansas, Kentucky, Maryland, Montana, New York, North Carolina, North Dakota, Oklahoma, Oregon, Utah, and Virginia. In the case of California and Georgia a resident is a natural person who is in the State for other than a temporary or transitory purpose. Spending a specified period of time or maintaining a permanent abode is merely presumptive of residence.

the State,[91] or is merely a citizen of the State.[92]

Domicile itself clearly affords a constitutional basis of jurisdiction for the imposition of State income taxes.[93] But the extent to which the States should, as a matter of policy, rely on domicile as a standard for determining who is taxable on his entire income, is open to question. The doubt is twofold. Domicile, being a common law concept, is not subject to statutory definition. It is established as a question of fact by the State courts.[94] Conflicting court decision on domicile need not be reconciled [95] and may result in multiple taxation. Furthermore, in some instances domicile is divorced from residence.

> To tax the entire income of a person who was not in the State during the year, nor possibly for many years, simply because he is domiciled therein, and to exempt a person who actually resides within the State, enjoying the benefits and protection of its laws and government, from the obligation of making a contribution to the cost of such government based on his total income, simply because he does not intend to make his home there indefinitely or has not abandoned his previous home, appears arbitrary and capricious.[96]

(4) *Double domicile in income taxation.*—It has been said that commonly and naturally a person has only one domicile. The possibility of any individual's having more than one is likely to be associated with a tax-evasion scheme.[97]

However, while most of the litigations revolving about domicile under the death taxes may have their origin in an intent on the part of the deceased to evade taxes, such is probably not the general case in connection with the income tax.[98]

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91 Alabama, Arizona, California, Iowa, Louisiana, South Dakota, West Virginia, Wisconsin, and Idaho.

92 Delaware and Louisiana.

93 *Lawrence* v. *State Tax Commission* and *Cohn* v. *Graves*, supra.

94 L. A. Tanzer, "State Income Taxation with Special Reference to the New York Income Tax Law," Proceedings of the National Tax Association, 1919, p. 388.

95 Dorrance, etc.

96 Frank M. Keesling, "The Problem of Residence in State Taxation of Income," California Law Review, vol. 29, September 1941, p. 720.

97 "There appears to be no legal problem of double domicile for the reasonably prudent and honest decedent.

"* * * Double domicile difficulties in death-tax cases arise only (*a*) through attempts by decedents to evade or avoid their share of taxes or other public obligations, and (*b*) through gross negligence on the part of those leaving valuable estates." James W. Martin, "A Comment on the Report of the Committee on Double Domicile in Death Taxation,"—Minority View, Proceedings of the National Tax Association, 1940, p. 258.

98 An excellent illustration of the latter is provided by the case of *District of Columbia* v. *Murphy* (314 U. S. 441 (1941)).

The District Income Tax Act lays a tax on "the taxable income of every individual domiciled in the District of Columbia on the last day of the taxable year * * *."

Persons who have always lived in the District of Columbia are clearly taxable. The difficulty arises in regard to those persons resident in the District on the last day of the taxable year who previously had a domicile elsewhere. The question is whether, by accepting employment with the Federal Government and living in the District, such persons have become "domiciled" there.

The Supreme Court stated in the Murphy case that a person does not acquire a "domicile" in the District merely by coming there to live for an indefinite period of time while in the Government service. On the other hand, a Federal officer who lives in the District and has no "fixed and definite" intent to return and make his home at the exact place where he formerly lived will be considered "domiciled" in the District. However, while the intention to return must be fixed, the date need not be.

The essential elements of domicile, a common-law concept, have been residence in fact, coupled with the purpose to make the place of residence one's home. (*Texas* v. *Florida*, 306 U. S. 398 (1939), p. 424.) In the Murphy case, the Court widened the concept; residence in fact, coupled with "no fixed and definite" intent to return to one's former home, constitutes a District of Columbia "domicile." The Court has therefore established a rule of presumption of intent to stay, with the burden of disproving the validity of the assumption in each case resting on the individual.

A person's statement of a "fixed and definite" intent to return to the previous place of residence will be given fair consideration, but such testimony alone will not suffice. Other proofs of intent are necessary. Certain acts must be established as facts, on the basis of all the surrounding circumstances both at the time of original removal and subsequently. To be considered are the nature of the position held, the manner of living, social and financial connections, retention and strength of affiliations in the community of origin, maintenance of the voting franchise, and payment of taxes in the old community which might be avoided by surrendering that domicile. (The analysis of the Murphy decision is abstracted from an intradepartmental memorandum of the Treasury Department, February 25, 1942, General Counsel Memorandum, on the Application of the District of Columbia Income Tax to Officers and Employees of Department of the Treasury, Office of the Administrative Assistant to the Secretary.)

Domicile has always been connected with the intent to make one's home at a given place, coupled with the act of doing so. A domicile once acquired is retained until a new one is acquired in another State. To

(5) *Domicile versus residence.*—Although generally domicile and residence coincide, instances of persons being domiciled in one State while residing in another are not infrequent.[99] In *Lawrence* v. *State Tax Commission* the Court stated that the tax in question was—

> founded upon the protection afforded to the recipient of the income by the State, in his person, in his right to receive income, and in his enjoyment of it when received.[1]

Although the Court stated that these were rights and privileges incident to domicile, they are extended equally to all persons within its limits, whether there for temporary or permanent purposes, and regardless of their intentions as to the duration of their stay. It appears equitable and reasonable to tax all persons who enjoy these rights and privileges.[2] While residence may be in some cases something less than domicile, it ought to be sufficient to sustain a tax identical in scope with one based on domicile.

Domicile is also an impractical test of jurisdiction. Since domicile depends so largely on one's intention, it is difficult to discredit claims by local residents of domicile elsewhere. Furthermore, enforcement of the tax on local domiciliaries who reside elsewhere is virtually impossible. Generally the existence of such persons and the amount of their income cannot be ascertained. Even if this information became available, through returns filed with the Federal Government, for instance, there is no effective method of compelling payment of the tax unless the taxpayer owns property in the State.

(6) *Physical presence for specified period.*—Several States provide that, if an individual spent in the aggregate a prescribed length of time during the taxable year—usually 6 or 7 months—he is classed as a resident, and is taxed on his entire income for that year. This provision appears to be valid, as a reasonable administrative device.[3] Conceivably, such a provision would induce taxpayers with sizable incomes to keep a scrupulous record of the time spent within the State and to depart before the lapse of the prescribed period. Also if the prescribed period were taken at 6 months or more, it might happen that a taxpayer would not spend that long a period of time in any State, and accordingly, would not be taxed in any State as a resident.

Most serious of all, however, under such a provision, a person whose stay within the State for the prescribed period happened to fall within this taxable year would be taxable upon his entire income for that year, whereas another person, although present within the State for an equal or even greater length of time within a 12-month period, but whose stay fell partly in one taxable year and

acquire a new domicile, one must reside at the new place, intend to make one's permanent home there, and intend to abandon the former home. The State courts have been the final arbiters of domicile and changes in it, with very little interference from the Federal Government. While the courts, of course, base their decisions on the common law, which is substantially the same from State to State, they do determine the weight of the evidence. In this matter, every court is independent, paying little attention to the views other courts express regarding the same set of facts. To this type of diversity making for double taxation, the Supreme Court has added in the Murphy decision another factor: Domicile can now be based on residence in fact, coupled with the intent to make the place of residence one's home as well as on residence in fact, coupled with no fixed and definite intent to return to one's former home.

[99] *Gould* v. *Gould* (235 N. Y. 14, 138 N. E. 490 (1923)). Husband and wife, who were married in Paris, lived there 6 years, were held domiciled in New York. *Harris* v. *Harris* (205 Iowa 108, 215 N. E. 661 (1927)). Held that an individual retained the domicile he had when he joined the Army, although he served for 35 years and was stationed at various posts.

[1] 286 U. S. 276 (1932), p. 281.

[2] In *Ryan* v. *Lynch* (262 N. Y. 1, 186 N. E. 28 (1933)), the court held that "In personal and income taxes domicile plays no necessary part. Residence at a fixed date has determined the liability for the tax."

[3] As applied to residents, an income tax is a personal tax, a tax on the privilege of an individual to enjoy the protection and benefits of the laws of that State. It is arguable that just as a State has jurisdiction to exact a tax from residents even though income from extraterritorial sources is included in the base of the tax, so the State may reasonably tax an individual within its jurisdiction at some time during the year, even though income received by the individual during a period he was not within the jurisdiction of the taxing State is considered. (See Keesling, op. cit., pp. 722-23.)

partly in the succeeding year might not be within the State for the prescribed period in either year, and hence would not be taxable as a resident in either year. Thus, rank discrimination would result between taxpayers. * * * [4]

(7) *Permanent place of abode.*—Several States have an alternative to the time-spent criterion of residence. They provide that a person maintaining a place of abode within the State limits is subject to taxation upon his income from all sources. If jurisdiction to tax from extraterritorial sources is founded upon the protection afforded the recipient in his person and in his right to receive and enjoy the income, a tax on income from such sources based simply on the maintenance of a place of abode, unaccompanied by domicile or presence within the State, would probably be invalid.[5] However, it is likely that a person having a place of abode within the State will be there for at least a portion of the year. The jurisdiction to tax his entire income might possibly be upheld on that ground. However, many people maintain places of abode in several States, and they might not occupy one of them in the course of a taxable year. And if they should be present in each of these States some time during the year, they become subject to multiple taxation.

(8) *Residence for other than temporary or transitory purposes.*—Another possible solution of the problem of determining the proper basis for the taxation of the entire incomes of individuals is to base the tax upon residence within the State for other than temporary or transitory purposes. This type of residence, once established in the State, is not lost by temporary absences. Like domicile, it implies a settled, more or less permanent relationship. Residence differs from domicile principally in that the absence of an intention to remain indefinitely or a present intention some day to return to a former residence does not prevent the acquisition of a new residence, even if it does prevent the acquisition of a new domicile.

The use of this concept of residence as the basis of jurisdiction to tax income might be criticized on the ground that it will result in the taxation of income received and accrued during periods the recipient is absent from the State. * * * The use of domicile as the basis, however, may result in the taxation of income of persons absent from the State for long periods of time and who may in fact have acquired a residence elsewhere. Clearly a person cannot be considered present in the State for more or less permanent purposes, and hence a resident of such State, if he is absent from the State for a long period of time or has become a resident of some other State. Accordingly, the use of residence as a basis of income taxation does not result in the taxation of income of persons absent from the State to the extent they would be taxed if domicile were the basis of taxation.[6]

Every person is always domiciled in some State. However, it may happen that at times one may not be in any State for other than temporary or transitory purposes, and hence not be a resident of any State. In order to prevent evasion in such instances, the States might properly rely on domicile as a basis for income taxation. They could provide that during the time a person is not a resident of any State, his income shall be taxable by the State of domicile.

At times, definition of residence may not be easy. Still, the problem is no greater than that of defining domicile. Remaining in the State for a prescribed length of time—6 or 7 months—or maintaining a permanent place of abode could be made presumptive

[4] Ibid., p. 724.
[5] Ibid., p. 725.
[6] Ibid., p. 728.

indications of residence, subject to rebuttal by the taxpayer's proof that he was in the State for temporary purposes only.

The problem of multiple taxation due to conflicting definitions of residence is greater than it appears to be.

> The question of domicile or jurisdiction, while it probably arises in the cases of a relatively small percentage of the total number of taxpayers, is an extremely important one in its practical aspect, since it affects a relatively much higher percentage of the total receipts from the operation of the law. This difference in proportion is undoubtedly due to the fact that questions of domicile arise with relative infrequency in the case of the taxpayer of average means since he is less likely to maintain more than one place of residence.[7]

Aside from its present quantitative importance, there is the fact that a prosperous economy requires fluidity and movement of population. Taxation should be no obstacle to the mobility of labor and enterprise. As the income tax widens and deepens in scope, the poor laborer is also affected by this problem, which formerly was only the concern of the wealthy.

While residence is probably the preferable basis for asserting jurisdiction over the totality of an individual's income, it gives no indications of determinate and unique solutions in every case. The escape from the subjective consideration of intention may simplify the problem somewhat. Yet the taxpayer who recurrently spends a portion of the year within the State cannot be assigned a residence without considerable hesitation. In doubtful cases, 2 States may well claim one person as a resident. This would probably occur in a case in which the time period criterion was inoperative; both States could claim a permanent place of abode and each might be reluctant to surrender tax jurisdiction to the State of domicile. As in other matters, uniformity of decision is required, which only a single administrative authority can secure.

(9) *Domicile of corporations.*—The proposal that residence, not domicile, be the criterion of full taxability under the individual State income tax has its limited counterpart in the corporate field.[8] Corporate income taxation is almost universally based on origin, very seldom on domicile. However, the State of domicile does have the potential power to tax all of the income of a corporation it has incorporated; and, more to the point, it plays a substantial role in the specific allocation of the nonbusiness income from intangible property of interstate corporations.

Until recent years, it was generally understood that except in the case of intangibles which acquired a business situs elsewhere, intangible property owned by a corporation was taxable only at the corporation's domicile, i. e., the State of incorporation. However, in *Wheeling Steel Corporation* v. *Fox*[9] the Supreme Court held that intangibles owned by a corporation having its principal place of business within the State where its directors met and the principal offices were located, and where the active management and control of the business were exercised, had a situs for taxation in that State, even

[7] Irving L. Shaw, "Domicile as the Criterion of Liability to Personal Income Taxation," Proceedings of the National Tax Association, 1920, p. 314.

[8] Charles W. Gerstenberg, chairman, "Report of Committee on Simplification of State Taxation of Business Concerns," Proceedings of the National Tax Association, 1926, p. 158.

[9] 298 U. S. 193 (1936).

though the corporation was domiciled elsewhere. To hold that intangibles were taxable in the State of incorporation to the exclusion of the State where the management functioned would, according to the Court, make a legal fiction dominate realities.

(10) *Apportionment.*—In the apportionment of corporate income, the problem of multiple taxation is quite as difficult as in the case of individuals. Sometimes corporations keep separate accounts of their business by States. There are judicial decisions which permit them to be taxed on such division unless it can be shown to be unreasonable. But ordinarily no division is attempted by the corporation and the States are compelled to establish rules of procedure for making such division themselves.

States have developed a considerable variety of formulas for accomplishing this jurisdictional division of corporate income. A formula widely acclaimed as fair and appropriate is that employed by Massachusetts. This State lays down the general rule [10] that income of interstate corporations shall be apportioned according to the average three ratios, (1) the percentage of all the corporation's tangible property located within the State, (2) the proportion of wages and salaries paid within the State, and (3) the proportion of gross receipts (sales and rentals and royalties) obtained within the State. The National Tax Association has recommended a standard formula which allows equal weight to three factors, tangible property, sales, and expenditure for wages and salaries.[11] The sales factor is defined to allocate activity to the State in which the sales office is located and from which it makes its sales. This leaves unrecognized the claims, if any, of the area in which the company's customers are located. Quite recently a committee of the association has recommended [12] some recognition of the latter interest but the recommendation involves heavy difficulties, both theoretical and practical. In practice, tax commissions find these formulas too general to be applicable to all interstate corporations and employ them as principles to be guided by rather than as hard and fast rules of measurement.

If all States used the same standard for the division of corporate income, the problem would be unimportant. But, as previously indicated, the States use different standards. Some, e. g., South Carolina, use tangible property as the sole criterion, while others, Missouri, for instance, employ only sales as the basis for apportionment. This makes both complete exemption and complete double taxation possible. The former would occur in the case of a corporation which had all of its property in Missouri and made all of its sales from a South Carolina office, while the latter would occur in the case of a corporation that had all of its property in South Carolina and made all of its sales from a Missouri office. Further difficulty arises in connection with nonbusiness income of corporations, particularly that from securities.[13]

[10] The apportionment formula applies to certain business income only; income from securities, for instance, follows the domicile of the corporation.

[11] Proceedings of the National Tax Association, 1933, p. 396.

[12] Proceedings of the National Tax Association, 1941, pp. 583-603.

[13] The apportionment problem is discussed in more detail below.

It has been proposed that the States be prohibited from imposing taxes on corporations, measured by net income arising in interstate commerce—

> * * * unless the portion of said income subjected to taxation is determined and set apart by methods of allocation and apportionment approved by a commission created by Federal act. The commission shall prescribe such rules and methods of allocation and apportionment of income derived from interstate and foreign commerce as in its judgment will avoid double taxation and permit each State to tax the portion thereof reasonably attributable to business conducted within its borders.[14]

This solution would probably be constitutional.[15] Its defects lie in its avoidance of the problem of allocating the intrastate incomes of unitary interstate businesses[16] and in its disregard of the costs of multiple administration and compliance.

A more comprehensive solution has been offered by Robert S. Ford, one of the leading students of interstate income allocation. The best expedient, in his view, is to federalize the administration of the State income tax.

> The Federal tax on corporate income would be levied in lieu of State taxes of this type, the proceeds being distributed among the States according to the source of income. But what criteria should be used in determining the source of corporate income? This is the perennial question. The allocation problem that confronts the States at present would be simply transferred to the Federal Government. However, under Federal administration it would involve an allocation of the proceeds of the corporation income tax rather than the allocation of net income among the States for taxation purposes.
>
> Such a transference of administration is highly desirable because it would automatically eliminate the problem of nonuniformity and objectionable double taxation by overlapping jurisdictions. It would abolish the evils of dual administration, as well as remove the difficulties of distinguishing between intrastate and interstate commerce. In selecting criteria for determining the source of income, the Massachusetts rule or the plan of the National Tax Association might fit in adequately with the system of integration.[17]

Tax sharing, the method suggested by Ford, is of doubtful acceptability. There is no need to go so far, in any case. The problem of distinguishing interstate from intrastate income is, on the whole, not relevant to the problem of allocation. There is reason to believe that Federal or joint administration of State supplements, reinforced by conditional Federal deductibility, or other conditional Federal advantages, would provide sufficient implementation to achieve the desired uniformity.

(*d*) *Capital stock taxation.*

Capital stock taxes, employed by about two-thirds of the States, also present apportionment and multiple taxation problems. Many States, such as Michigan, attempt to tax only that portion of capital stock employed within their borders. The problem here is quite similar to that found in the division of net income, and the techniques employed show a similar diversity. A recent Supreme Court decision allowed Texas to apportion a capital stock tax on the basis of gross income earned within and without the State.[18]

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[14] Robert S. Ford, "Allocation of Corporate Income for the Purpose of State Taxation," Special Report to the New York State Tax Commission, No. 6, 1933, pp. 98–99, citing a proposal by W. S. Elliott in Proceedings of the National Tax Association, 1932.

[15] Ibid., p. 118.

[16] Throughout his monograph, Robert S. Ford emphasizes the difficulty of distinguishing between intrastate and interstate business income for allocation purposes. (See pp. 35 ff., 94, 118, et passim.) Admittedly, such a segregation would be difficult to achieve. However, there is little reason to fear the complexity of a problem which requires no solution. There appears to be no considerations, economic or legal, which call for a solution. *Alpha Portland Cement Company* v. *Massachusetts* (268 U. S. 203 (1925)) is a minor exception.

[17] Ford, op. cit., p. 121.

[18] *Ford Motor Co.* v. *Beauchamps* (308 U. S. 331 (1939)).

4. QUANTITATIVE ASPECTS OF THE PROBLEM

How much overtaxation results from the "importation of value" in the administration of ad valorem taxes as applied to railroads; in the application of corporate income-tax apportionment; in the multiple taxation of intangibles under the death tax; in cases of double domicile; in "importation of value" under capital-stock taxes? Concerning the answers to these questions, there is almost no evidence. Surely here is a virgin field for research which challenges the attention of those who are interested in the maintenance of our Federal system. As previously suggested, the matter might well engage the attention of any Federal-State commission that might eventually be established. But it is doubtful whether the amount of multiple taxation is its most serious aspect. As in the case of tax-exempt securities, it is the inequities involved that are most lamentable. The inequities here, as distinguished from the tax-exempt security field, are due to special burdens rather than immunities; but they are very real and important in both cases. Double-domicile cases may occur only once in a hundred thousand instances of death-tax application. But when they do occur, they discredit the whole tax system. Moreover, there are serious economic effects which result from special hazards and burdens heaped upon cosmopolitan taxpayers. A businessman who hesitates to extend his business into more than one State because of the hazards of multiple taxation may safeguard himself by the decision to confine his operations to a single jurisdiction. But his decision may have the antisocial consequences that the framers of our Federal system sought to avoid when they ruled out State legislation discriminating against interstate commerce.

5. WHAT CAN BE DONE ABOUT MULTIPLE TAXATION?

Since the Supreme Court appears ready to wash its hands of the multiple-taxation problem, the question of what can be done about the matter is particularly timely. Several approaches and attitudes toward interstate multiple taxation may first be listed and considered.

First, there is the view that nothing can or need be done about multiple taxation; that the problem is exaggerated; that it is principally big taxpayers who suffer and these can afford good lawyers to keep them out of trouble; that the difficulty represents, in any event, but a necessary price which we have to pay for our Federal system. As previously suggested, this view, in the authors' judgment, is not tenable.

Second, the view is expressed that the States can and will solve their own problem. In most, though by no means all cases, they have little to gain from multiple taxation which exists largely as a result of inertia and the difficulties of getting States to agree and act on a cooperative program. The States have and should have, to spur them on, the threat of Federal occupation of fields where failure to cooperate leaves intolerable impediments to national economic development. State action through reciprocal legislation and other cooperative devices is much to be preferred to Federal action. But judging by past performance it is quite probable that State efforts will prove "too little and too late."

Finally, there is the possibility of the Federal Government doing something about the problem. Though the Supreme Court abdicates the field, there is still Congress and the Federal administration to fall back on. Even the suggestion of such action will be warmly resented by those who feel that the Federal Government already has too much power and that the unwillingness or inadequacy of judicial action to clear the tax field of multiple taxation should not serve as a pretext for Federal legislative interference. The authors have some sympathy with those who fear an extension of Federal power. But it is sometimes necessary to make concessions in order to preserve the essential elements of an existing arrangement. This is a case of amputating a finger to save the arm. The Federal Government is in an especially strategic position to deal effectively with interstate multiple taxation. There is no other agency in such an advantageous position to weigh all the interests, including those of the taxpayer, and to strike a balance. A Federal program may involve some immediate curtailment of State fiscal independence, but in the long run it will make such fiscal independence possible and enduring.

Along what lines should the Federal Government proceed? It should attempt, by offering the States inducements and subsidies, to gain the right to delineate State territorial jurisdiction to tax. In the case of the death-tax, this could be accomplished through a modification of the crediting device in such a way as to make dual administration unnecessary. A substitute form of Federal administration or joint administration could be arranged by agreement, one of the conditions of which would be the acceptance by the State of workable rules of jurisdiction. Similar arrangements in the income-tax field are more difficult but not impossible. It may be doubted that Congress and administrators are wise enough to perform successfully a role which the Supreme Court has rejected. But there is fair agreement concerning many matters of jurisdiction—a proper allocation formula for corporation income, for instance—and the States with a few exceptions have no very high stake in jurisdictional vested interests. Some jurisdictional problems will have to be settled by compromise. The rules that should be applied and the means of promoting them must remain somewhat vague for the present, but the outlines of a desirable procedure are fairly clear. They call for (1) conference and consultation between Federal and State officials as to acceptable uniform jurisdictional rules, (2) joint promotion of the application of these rules, (3) acceptance of Federal arbitration in cases of dispute, and (4) Federal development of incentives for State compliance. Present increasing multiple taxation acts as an unfortunate penalty upon cosmopolitan ownership and business, a sort of trade barrier, which it is the natural role of the Federal Government to prevent. The Federal Government should not shirk its proper task in the matter.

D. Trade Barriers [19]

1. NATURE OF THE FIELD

The subject of trade barriers is only partially in the field of intergovernmental tax relations. A trade barrier has been defined as "any State statute or regulation which, on its face, or in practical effect, tends to operate to the disadvantage of persons, products, or

[19] Based in part on a memorandum prepared for this study: A. B. Goodman, Tax Barriers to Interstate Trade.

services coming from sister States, to the advantage of local residents, products, and business."[20] This definition may be broad enough to include several forms of discrimination against interstate business as compared with intrastate business, for example, the multiple taxation and high cost of tax compliance imposed on interstate concerns (matters previously discussed). But the term is more often confined to legislation which operates like a tariff to promote home business at the expense of outside competition. The use of tax devices toward this end is exemplified by the State excises on the sale of oleomargarine and other agricultural products, taxes on imported liquor, ton-mile and license taxes on foreign-owned trucks as a condition of passage through a State, chain-store taxes, and use taxes which make no allowance for sales taxes in the State from which goods are purchased. Special subsidies to home plants, previously discussed, also have some of the earmarks of trade barriers. Impediments outside the tax field include direct restrictions on the importation of intoxicating liquor and prison-made goods, inspection regulations, labeling laws, and other conditions, imposed on interstate shipments of such commodities as plants, fruits, and vegetables, each beyond their legitimate purpose of policing. Regulation of truck equipment, weight, and insurance and port-of-entry inspections are cited as another source of trade barriers; and legislation providing a preference to in-State labor and materials for public employment and use is also often included in the list.

Trade barriers of these types are no new phenomenon but they were expanded substantially during the middle 'thirties.

The Marketing Law Survey of the Works Progress Administration in 1939 prepared a tabulation of State laws creating or tending to create trade barriers among the States. The Survey prepared charts of their findings showing extracts from State laws in the following classes: motor vehicles, 301 examples; dairy products, 209; oleomargarine, 245; livestock and general food, 138; nursery stock, 145; use taxes, 109; general preference, 113; commercial fishing, 35; and insurance, 69 examples. The preliminary tabulation included 1,489 State laws.[21]

During the late 'thirties trade barriers attracted wide attention and much comment. The Council of State Governments made the subject a feature item on its agenda. This educational drive had some effect in calling a halt to the trend toward more barriers and it is claimed that the trend was even reversed to some extent in 1939. The degree to which the barriers impede interstate business is not definitely ascertainable, but that it has been sufficient to cause a deep feeling of alarm is evident in such expressions as the following:

I have read all of the chapters (Report, Bureau of Agricultural Economics) on this great subject of interstate movement of farm commodities and noted the barriers and handicaps that are shown in your research work. I am amazed at the contents of these several chapters and the picture that you have been able to present * * *. One of two things, I am sure, will happen in consequence.

[20] Testimony of A. H. Martin, Jr., Executive Director, Marketing Laws Survey, Works Progress Administration, Federal Works Agency, before The Temporary National Economic Committee (76th Cong., 2d sess.), pt. 29, Trade Barriers, p. 15780.

[21] Paul T. Truitt, "Interstate Trade Barriers Among the States," Law and Contemporary Problems, vol. 8, No. 2, spring 1941, p. 213. It is estimated that the final tabulation will show over 3,000 trade-barrier laws on the statute books of the States. As a result of this tremendous expansion in trade-barrier legislation, the subject has received extended treatment and study—especially in the past 5 years. Among the more comprehensive studies are those by F. E. Melder, State and Local Barriers to Interstate Commerce in the United States, University of Maine Studies, Series 2, No. 4, 1937; G. R. Taylor and others, Barriers to Internal Trade in Farm Products, U. S. Department of Agriculture, 1939; "Intergovernmental Relations in the United States," Annals of the American Academy of Political and Social Science, vol. 207, January 1940; the excellent reports of The Marketing Laws Survey of the Works Progress Administration; Hearings of the Temporary National Economic Committee, Interstate Trade Barriers, 1941; "Governmental Marketing Barriers," Law and Contemporary Problems, vol. 8, No. 2, spring 1941; and Tax Barriers to Trade, Tax Institute, 1941. Each of these studies considered not only the barrier effects of certain taxes but also the restrictive trade characteristics of all types of regulatory laws and administrative practices.

Either the people of the several States will come to their senses and recognize that we have a union of 48 States instead of a disunion, or there will be drastic demands for Federal control over these matters. Sooner or later it should mean cooperation by all of the States and the Federal Government in place of individual State action or absolute Federal control.[22]

It is not difficult to state causes for the growth of trade barriers. One is the propensity of the individual to favor the "nearer good," so to speak, his inclination to support his neighbors rather than absentee interests; his readiness to respond to a "buy at home" slogan. Considering what has happened in the field of international trade, this should not surprise anyone. Another cause is the development of transportation and communication, opening the door of competition to the products of absentees and frequently threatening the security of the "little businessman" at home. Technological progress undoubtedly raises living standards for the majority of people in the long run, but in the short run and for some producers it may offer only prospects of terrifying insecurity.

The evidence indicates that most people are against trade barriers in the abstract but that there are many who support their own particular trade barrier in a concrete situation.

2. STATE TAXES TENDING TO EXCLUDE OUT-OF-STATE PRODUCTS—OLEOMARGARINE AND ALCOHOLIC-BEVERAGE TAXES

The two most important taxes tending to exclude out-of-State products are oleomargarine and alcoholic-beverage taxes. One essential difference between the two taxes is that margarine taxes as barriers to trade must operate indirectly because of the constitutional limitation on taxation of interstate commerce, whereas liquor taxes have no such prohibition.

(*a*) *Oleomargarine.*

About one-half the States impose margarine taxes. These taxes include both heavy licenses on manufacturers, dealers, and importers, and specific excises of 5 to 15 cents per pound. As of 1939, these excises had been adopted by 23 States, of which 16 required licenses (at fees ranging from $1 to $1,000 per year) to engage in the manufacture, distribution, sale or serving of oleomargarine. Of these, Montana, Pennsylvania, and Wisconsin are in the highest bracket.[23] North Carolina had a $1,000 license fee on manufacturers, which was repealed by the 1939 legislature.

Some States give statutory preference to oleomargarine containing varying proportions of domestic crops. For example, Maine, and the Cotton Belt States, except Mississippi and Oklahoma, exempt from margarine taxation those products containing cottonseed oil, corn oil, peanut oil, soybean oil, oleo oil and stearine, and certain other animal fats and oils, while cattle States, like Minnesota, Nebraska, and Wyoming, tax products not containing at least 65, 50, or 20 percent, respectively, of animal fats or oils.

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[22] Quoted from a letter from a State commissioner of agriculture, in Barriers to Internal Trade in Farm Products, p. 3.

[23] The Marketing Laws Survey, Comparative Charts of State Statutes Illustrating Barriers to Trade Between States (Works Progress Administration, 1939), p. 31. Also see J. W. Sundelson, "Banning the Use of Margarine Through Taxation," and C. H. Janssen, "The Trade Barrier Character of Oleomargarine Tax Laws," both in Tax Barriers to Trade, Tax Institute; and "Margarine," Barriers to Internal Trade in Farm Products, 1939.

In the beginning this legislation may have been intended to prevent "fraud" through substitution of oleomargarine for butter, but it has become principally a means of protecting "home" products, and bars the movement of margarine across State lines. As was indicated in the testimony before the Temporary National Economic Committee, at the present time margarine tax legislation indicates that the dairy States have sought to exclude margarine by practically taxing it out of existence, while the Southern nondairy States have sought to protect their margarine industry by taxing any competitive products not made from their own home-grown crops.[24]

As a consequence of the fact that the purpose of the tax is to "protect," little revenue is obtained from the oleomargarine taxes. In this respect it is much like the tariff. It has long been recognized that customs duties low enough to bring in a large amount of revenue give relatively little protection and that those that give real protection bring in practically no revenue. In 1939, Wisconsin obtained only $20, South Dakota $20, and Oklahoma $52 from oleomargarine taxation. Only Iowa received a significant amount of revenue from a tax on all margarine, namely $78,960. During 1939, only Iowa, Utah, and Pennsylvania got as much as one-tenth of 1 percent of their total revenues from this source.[25]

In surveying the problem from the point of view of fiscal policy, J. W. Sundelson concludes that there is very little to commend margarine taxation:

> Its incidence is regressive, in that direct and indirect burdens fall heaviest upon the elements of our population least able to pay. As far as the States are concerned, such taxation fails as a revenue producer. It has adversely affected the manufacture, flow of trade, and consumption of a commodity against which there is no socially supported reason for the suppression of nonfraudulent sales. Finally, it is a dangerous precedent for taxes sponsored by pressure groups. They distort competitive relationships without bringing compensating benefits to the general public.[26]

(*b*) *Alcoholic beverage taxes.*

Restrictions on interstate trade in liquor differ from all other trade barriers in that liquor is subject to whatever discriminatory legislation a State legislature may enact.[27] In most cases such legislation takes the form of differentials in excise taxes or license fees.[28] Other forms of trade barriers operate by indirection; otherwise the Supreme Court would remove them. In the case of alcoholic beverages, there is no such limitation. The result is that interstate restrictions are "open and above board."

The effect on interstate commerce in liquor has been considerable. Not only do the States provide preferential treatment for locally produced alcoholic beverages but they also can and do favor alcoholic beverages of one State as compared with another; as a consequence, the States have engaged in what Lepawsky has characterized as "back-yard quarrels" (rather than acts of statecraft); [29] they have punished

[24] Temporary National Economic Committee, Interstate Trade Barriers, pt. 29, p. 15785.
[25] J. W. Sundelson, "Banning the Use of Margarine Through Taxation," op. cit., p. 96.
[26] Ibid., p. 104.
[27] T. S. Green, "Tax Barriers to Trade With Respect to Alcoholic Beverages," Tax Barriers to Trade, Tax Institute, p. 103.
[28] R. E. Curtis, "Problems of Eliminating Liquor Trade Barriers," Tax Barriers to Trade, Tax Institute p. 145.
[29] Proceedings of the National Tax Association, 1939, p. 394.

each other for establishing these discriminations by engaging in retaliatory practices.

Historically, special treatment of liquor in interstate trade arose from the belief that States wishing to exclude or restrict the sale and consumption of liquor should not be hampered in this objective by Federal control over interstate commerce.[30]

To effect this purpose, the Wilson Act of 1890 required that liquor entering a State become immediately subject to the police regulations of that State. As one report puts it:

> Judicial interpretation greatly weakened the effectiveness of the law. But the Webb-Kenyon Act of 1913, and later the twenty-first amendment to the Constitution successfully freed the States from the restrictions of the interstate-commerce clause of the Constitution and gave them the right to prevent shipments in violation of their laws.[31]

The constitutionality of State laws that favor intrastate liquor manufacturers, dealers, and products has been sustained by the Supreme Court in *State Board of Equalization of California* v. *Young's Market Co.*, [32] the leading case on this subject. The Court upheld a California law that imposed a $500 license fee on importers of out-of-State beer.[33] In a later decision involving a Michigan embargo on Indiana beer, the Court reaffirmed and clarified its position as follows:

> Whether the Michigan law should not more properly be described as a protective measure, we have no occasion to consider. For whatever its character, the law is valid. Since the twenty-first amendment * * * the right of a State to prohibit or regulate the importation of intoxicating liquor is not limited by the commerce clause. * * * [34]

The compilations of the Marketing Laws Survey emphasize four barrier aspects of State liquor laws, most of which involve the application of the taxing power.[35] The first consists of tax and regulatory differentials favoring producers and products utilizing home-grown crops. Such preference laws have been passed by 26 States, most of which employ differential license fees favoring domestic liquor manufacturers who utilize in-State products.[36]

The second type of tax favoritism, also utilized to encourage use of home-State products and to discourage imports from other States, is the differential excise taxation of alcoholic products made partly or wholly from domestic raw materials. For example, the Michigan tax is 50 cents per gallon on wine manufactured from "foreign" products, whereas wine made in the State from products, 75 percent or more of which have been grown in the State, is taxed only 4 cents per gallon. A further provision of the Michigan law, peculiar to that State, is that Michigan grape growers must be paid a minimum of $55 a ton for their grapes before the special low-tax classification applies. Other States that impose a higher tax on imported than on domestic wines include Arkansas, Georgia, and New Mexico. In Arkansas the wine tax of 50 cents per gallon does not apply to

[30] Barriers to Internal Trade in Farm Products, p. 31.
[31] Ibid.
[32] 299 U. S. 59 (1936).
[33] This law was repealed in 1937.
[34] *Indianapolis Brewing Company, Inc.* v. *The Liquor Control Commission of the State of Michigan et al.* (59 Sup. Ct. Rep. 254 (1939)).
[35] The Marketing Laws Survey, Comparative Charts of State Statutes Illustrating Barriers to Trade Between States, p. 63.
[36] For example, Alabama charges manufacturers of alcoholic beverages an annual license fee of $1,000 for each place of manufacture, but wine makers using 75 percent or more of Alabama raw materials in their wineries pay only $25. (Tax Systems, 9th ed., 1942, p. 207; also Temporary National Economic Committee, Interstate Trade Barriers, p. 15786.) In Oregon the regular winery license is $250, but a farmer making wine from his own products pays only $25.

domestic wines;[37] and Georgia taxes dry wine 5 cents per gallon if made from native grapes, but 40 cents if made from imported grapes.[38]

A third method of encouraging the local liquor industry consists of tax exemption, or taxation at lower rates, of alcoholic beverages produced for export to other States.[39] At least 25 States grant such exemptions to domestic producers. (However, in this instance the classification may be reasonable and the procedure not open to criticism. The liquor tax is a consumption tax and should apply to home consumption only.)

And fourth, the development of protective legislation in the form of tax differentials on liquor has been accompanied by the appearance of administrative reprisals and retaliatory tax legislation. Testimony before the Temporary National Economic Committee in 1940 indicated that eight States had enacted retaliatory legislation against beverages from other States. The Rhode Island statute is representative of such legislation. Its law provides that the Department of Business Organization is authorized to assess the products of any State discriminating against Rhode Island products in such amounts as to equalize the taxes and other charges.[40] Missouri is also reported to have an especially drastic retaliatory law.[41] Connecticut, Ohio, Pennsylvania, and Florida have laws that provide for retaliatory taxes on out-of-State liquor from States believed to have discriminatory taxes. Legislation in Pennsylvania provides for retaliation by imposing taxes and fees on out-of-State beer to the same degree that other States discriminate against Pennsylvania beer.[42]

These retaliatory provisions have led to considerable bitterness among the States involved. The United States Department of Agriculture reported that numerous beer and liquor "wars," not unlike the truck-license "wars," have been waged among the States:

> In December 1935, "hostilities" broke out on the New York-Connecticut border. Liquor dealers in New York attempted to prevent residents of New York from buying in Connecticut where prices were cheaper. * * * Much more serious has been the struggle between Michigan and Pennsylvania. Discrimination led to retaliation and retaliation to further retaliation until, during the first few months of 1938, both States had taken measures to place an embargo on beer importations from the other. * * * The most spectacular of these struggles has been that in which Michigan, Indiana, and Ohio have been engaged since 1935. Charges and countercharges have been made. Each State has considered itself unfairly discriminated against. Practically all the weapons of modern tariff reprisal have been resorted to including retaliatory taxes, fees, and inspections; ports of entry; and absolute embargoes. At present there is a lull in the battle between Michigan and Indiana, both States having now removed their embargoes. But the Michigan embargo on beer from Ohio is still in effect and Indiana-Ohio relations are decidedly strained.[43]

The reasoning underlying these restrictions on interstate trade in liquor products appears to be partly moral, partly economic. Many people believe that consumption of alcoholic beverages cannot be too severely restricted, and that every impediment to the liquor trade is

[37] Temporary National Economic Committee, Interstate Trade Barriers, p. 15786.
[38] Barriers to Internal Trade in Farm Products, p. 33.
[39] Marketing Laws Survey, p. 63.
[40] Temporary National Economic Committee, Interstate Trade Barriers, p. 15788.
[41] Barriers to Internal Trade in Farm Products, p. 33.
[42] A similar situation appears to have developed in Argentina. There the tendency of provinces to levy duties on interprovincial trade in the form of municipal taxes was noted as early as 1887. The Province of Salta at one time levied taxes on beer manufactured outside the Province at rates that were double those on local beer. The Province of Jujuy levied taxes at 0.02 peso per liter for provincial wine, 0.15 to 0.25 peso per liter for wine manufactured elsewhere in Argentina, and 0.30 peso per liter for wine of foreign manufacture (B. Lewis, A Shared Tax Plan in Argentina, A. M. thesis for City College, New York, 1940, unpublished).
[43] Barriers to Internal Trade in Farm Products, pp. 33-34.

a good one. Acceptance of this view would require the equal application of restrictions to all liquor, regardless of its nature, the location of the producer, the source of raw materials, or the location of customers. But such is not the case. It is interesting that "these restrictive laws apply in large part to beer and wine and not to distilled liquors in spite of the fact that it is in relation to distilled liquors that the need of control is deemed greatest from the standpoint of public health and morals." [44]

The explanation for greater tax restrictions on beer and wine is an economic one. The manufacture of distilled spirits is highly concentrated in large-scale industries located in only a few States. Only 28 States have any production, and 98 percent of the total gallonage is produced in 9 States. Opportunities to develop new centers of production are limited. One is led to the conclusion that the few existing tax barriers to trade in distilled spirits are offshoots of the general trade barrier movement and have their roots in legislation protecting beer and wine, rather than in economic factors of their own.[45]

The manufacture of beer and wine, especially the latter, is more widely scattered, and freedom of entry into the beer and wine industries is apparently much greater than that into distilling. Hence the response to differential tax advantages is also likely to be greater. Protection of local grape growers and their wineries is the main reason for favoring in-State wine. Also the difference in processing costs between large and small wineries is an important factor. Small farmers operating their own wineries fight to preserve their local markets from the competition of importers from areas dominated by large producers.[46]

In contrast, the farmer is not so vitally interested in the location of the beer business. Rather, the source of the beer-barrier legislation is to be found in the competition among the brewers:

> During 1937–38, 615 breweries were listed, scattered among 40 States. Half a dozen States had but one brewery, while the figures ran as high as 84 in Wisconsin and 103 in Pennsylvania. Thirteen of these States produced more than a million barrels each a year, and accounted for 87½ percent of the national total. Thus we find that although both farmers and brewers are interested in maintaining unrestricted interstate shipment of agricultural products, the marketing of the beer itself is usually subject to stiff competition between local breweries as well as between the national and local brewers. Individual brewers want protection in their already overcrowded markets and seek the support of the legislature in this endeavor.[47]

The conclusions of the Department of Agriculture with respect to interstate liquor barriers seem justified by the facts presented above. In its study, Barriers to Internal Trade in Farm Products, the Department reports agreement on the following principles:

> Each State should be permitted to control the consumption and sale of alcoholic beverages within its own borders whether such beverages are produced within the State or in some other parts of the country. But the question arises, in exercising such control should States be permitted to enact legislation favorable to local products or to in-State distributers or producers? Neither for the protection of public morals nor for the enhancement of the economic welfare of the whole country does such discrimination seem justified.[48]

[44] Ibid., p. 34.
[45] T. S. Green, op. cit., p. 193.
[46] Ibid., p. 138.
[47] Ibid.
[48] Barriers to Internal Trade in Farm Products, p. 35.

3. INSURANCE TAXES

Although not ordinarily included in discussions of interstate trade barriers, insurance taxes operate in several ways to interfere with the interstate insurance business. The source of the impediments may be found in (*a*) the almost universal retaliatory provisions of State insurance-tax laws; (*b*) the amazing complexity and diversity in tax rates, deductions, and bases; (*c*) rate differentials which discriminate against out-of-State companies (referred to hereinafter as "foreign" companies); and (*d*) tax concessions to those companies which invest their assets in securities specified by the taxing State.

The predominant form of tax on life and fire insurance companies, both domestic and foreign, is the gross premiums tax, to which this discussion is limited. For example, 45 States apply the gross premiums tax to foreign life-insurance companies, 46 to foreign fire-insurance companies.[49] Retaliatory clauses are found in 43 State laws taxing foreign life-insurance companies and in 37 taxing foreign fire-insurance companies.[50]

Retaliatory tax laws commonly provide that foreign companies doing business in the taxing State shall pay either a specified minimum rate [51] on gross premiums or that rate which the home States of such companies apply to the domestic companies of the taxing State. It should be noted that retaliatory treatment is not confined merely to tax rates, deductions, and bases but extends to the regulations which prescribe conditions under which foreign companies may do business in a given State. Thus, "to increase taxes upon foreign companies is, in effect, to increase the taxes on domestic companies." [52] This is presumed to protect the latter from excessive taxes by States other than their home States (since the home States will be hesitant to raise rates on foreign companies and thereby invoke higher rates on their own companies). It is claimed that retaliatory provisions thereby tend to discourage discrimination and to keep State insurance taxes in line.

However, a number of nonconformist States have enacted high and discriminatory rates on foreign companies. Since in such instances the tax payable by a domestic company to the home State is low while the tax payable to each State with a retaliatory law is high, these States have in effect set up barriers to the extension of their own domestic companies' business beyond the home-State lines. If, on the other hand, the taxing State has low minimum rates on foreign companies, and no differentials in favor of home companies, the interstate flow of insurance business is not impeded.[53] Here, then, is the curious case in which a given State (the home State) can build or remove other States' tax barriers to its domestic companies!

[49] Gross premiums taxes also predominate in the taxation of domestic companies, but several other methods of taxation, under both general and special tax acts, are applied. Among the special taxes are those on investment income, on shares of stock, and on policyholders' reserves.

[50] Tax Systems, 9th edition, 1942, pp. 293-300.

[51] These minimum, or primary, rates on legal reserve life-insurance companies range from 1.5 percent in Delaware and Georgia to 4.65 percent in Texas. Most States fall in the range from 2 to 2.5 percent.

[52] K. M. Williamson, "Reciprocity and Retaliation in Insurance Taxation," Proceedings of the National Tax Association, 1938, p. 464.

[53] One observer summarizes the situation as follows: "The company whose home State has a high tax rate and a minimum of deductions and extensive regulations and prohibitions [applicable to foreign companies] is most adversely affected by the retaliatory laws and conversely companies from those States which have a low rate and a maximum of deductions and a minimum of regulations are the least affected by the retaliatory acts." George B. Young, "Discussion on Reciprocity and Retaliation in Insurance Taxation," Proceedings of the National Tax Association, 1938, p. 483.

The barrier effect of differential rates which discriminate against foreign companies, is of course, not limited to restriction of exit of home companies, for the more conventional barriers to entry of out-of-State businesses are also set up in each State that imposes higher minimum rates on foreign than on domestic companies. Examples of States with differential rates adverse to foreign life insurance companies are Alabama, Iowa, and South Dakota (1 percent on domestic companies, 2.5 percent on foreign), Maine (1 percent and 2 percent), Texas (0.625 percent and 4.65 percent), and Washington (1 percent and 2.25 percent).[54]

In addition to impeding the flow of insurance business across State lines, certain State tax laws tend to distort the "natural" flow of investment of insurance company assets. In Colorado, Georgia, Idaho, Louisiana, Mississippi, Montana, New York, South Carolina, Texas, and Washington the taxes on life insurance companies are reduced if stipulated percentages of the assets of the company are invested in approved State or local securities. For example, the standard minimum rate in Georgia is 1.5 percent, but if one-fourth of total assets is invested in prescribed Georgia securities, the tax is 1 percent while if three-quarters are so invested, the tax is 0.25 percent.[55] These attemps to retain or import foreign capital and, collaterally, to strengthen the market for State and local securities are similar in principle to the granting of tax concessions to migratory industries.

A final barrier aspect of State insurance-tax laws is found in their "extraordinary lack of uniformity * * *."[56] The premiums base is definied differently in almost every State, and the multiple bases of taxation employed by foreign States are imported into the States with retaliatory taxes when the companies of foreign States do business in the States with retaliatory taxes. The burden of compliance imposed by these laws is very great [57] and may have the effect of discouraging insurance companies from doing business in more than a few States.

The foregoing discussion reveals four barrier effects of State insurance taxation: (1) The combination of retaliatory laws and high discriminatory rates on foreign companies imposes a barrier to the exit of domestic companies; (2) discrimination in rates discourages entry of foreign companies into the taxing State; (3) tax concessions for investment of assets or reserves in State and local securities act as artificial impediments to the free flow of investment; and (4) complexity and diversity of laws impose a great burden of compliance on those companies which venture into numerous States. While the differentials in insurance company burdens probably are too low to have seriously discouraged the interstate transaction of insurance business and while fiscal[58] rather than protective motives have usually been involved, the problem of trade barriers in the insurance field has considerable potential importance.

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[54] Tax Systems, ninth edition, 1942, pp. 293-295.

[55] Ibid., pp. 292-296.

[56] K. M. Williamson, op. cit., p. 443. Williamson's paper contains an illuminating discussion of diversities, complexities and conflicts in State insurance taxation. His conclusions are of considerable interest: 'Whatever advantages retaliation and reciprocity may have in preventing excessive taxation of insurance companies, these practices have not only failed to remove the lack of uniformity in taxation, but have actually increased it. In addition, these systems have greatly enlarged the burden of tax administration. It would, thus, appear that the disadvantages of these devices outweigh their advantages, and that a more promising approach to uniformity in State taxation of foreign insurance companies could be made through the avenue of administrative and legislative cooperation" (p. 479).

[57] The difficulties and cost of administration are of course increased at the same time.

[58] See further discussion, p. 468.

4. MOTOR-VEHICLE TAX BARRIERS

The Marketing Laws Survey reported that the motor-vehicle laws present perhaps the greatest barrier to trade between the States.[59] While it is true that these barriers in favor of domestic vehicles, on their face, do not discriminate against out-of-State vehicles, they do operate as a cumulative burden on vehicles which must pass through several States paying fees in each. "Such cumulative burdens, justified perhaps for the use of the highways, may yet, when pyramided against a single vehicle, constitute a real handicap and interference with motor transportation." [60]

From the standpoint of interstate commerce, the problem concerns trucks and busses primarily; at the present time there is complete reciprocity among the States in the recognition of license plates of visiting passenger cars.[61] With respect to persons moving their residences from one State to another, however, a multiple tax problem arises which is not unlike that encountered by trucks engaged in interstate commerce.

Barriers to the interstate movement of trucks and busses arise from the exercise of both the taxing power and the police power. As to the first, the principal problem is the necessity for vehicles operating between States to register in each State and pay the same fees as intrastate operators. As to the second, varying safety requirements and restrictions on weight, length, height, width, and speed seriously hamper the free movement of traffic from one State to another. The recent Federal-State agreement on truck specifications has, to a considerable extent, eased these restrictions for the duration of the national emergency.

(*a*) *State taxes and fees on interstate carriers.*

It is now well established that the States may impose taxes and fees on interstate motor carriers when the purpose is to obtain compensation for the use of the State's highways or to help cover the cost of regulation and policing.[62] Even when special taxes are levied on interstate carriers, they may be approved by the courts unless it can be shown that such taxes are clearly discriminatory or have no reasonable relation to the privileges granted.[63] Past action by the Federal courts indicates that laws that are shown to be clearly discriminatory or deliberately designed to burden interstate commerce are unconstitutional.[64] Therefore, because of these limitations on the taxing power, State taxes on out-of-State vehicles are nominally nondiscriminatory; that is, no distinction is drawn between resident and nonresident operators. Both pay the same basic registration taxes and other charges for use of the highways within the State. The great disadvantage to interstate commerce comes from the requirement that out-of-State trucks must take out a second registration. An interstate operator may be registered in two or more States and pay annual registration taxes in each, while the operator

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[59] Marketing Laws Survey, Comparative Chart of State Statutes Illustrating Barriers to Trade Between States, p. 1.

[60] Ibid.

[61] However, visitors' permits must be obtained by motorists in the following 13 States: Arizona, Arkansas, Iowa, Massachusetts, Minnesota, Mississippi, Montana, Nevada, Oklahoma, Oregon, Texas, Utah, and Virginia. After 25 days, a fee is required in 2 States—Mississippi ($1) and Texas (50 cents).

[62] See for example, *Hendrick* v. *Maryland* (235 U. S. 610 (1915)); *Kane* v. *New Jersey* (242 U. S. 160 (1916)) *Clark* v. *Poor* (274 U. S. 554 (1927)).

[63] *Interstate Busses Corp.* v. *Blodgett* (276 U. S. 245 (1928)); *Ingle* v. *Norf* (300 U. S. 290 (1937)).

[64] *Sprout* v. *South Bend* (277 U. S. 163 (1928)); *Interstate Transit, Inc.* v. *Lindsey* (283 U. S. 183 (1931)).

who never leaves the home State pays only one annual registration and at the same time may operate over an equal or greater territory. For example, testimony presented to the Temporary National Economic Committee pointed out that a trucker with a 5- to 6-ton truck (no trailer), traveling from Alabama to South Carolina, would be required to pay $400 in Alabama, $400 in Georgia, and $300 in South Carolina or a total of $1,100. Trucks operating within one State would pay only one of the above fees.[65]

The States differ greatly among themselves on licensing requirements for foreign vehicles. A number of States are very liberal and make no attempt to require private carriers from outside the State to take out licenses so long as they do not engage in intrastate business. Usually, but not always, the granting of such favors is contingent upon the granting of reciprocal privileges by the other States whence the motor vehicles came. Representative States in this group are Massachusetts, New York, California, and Ohio.[66]

At the other extreme are a second group of States that require practically all out-of-State trucks to register and pay a fee, or alternatively, to pay higher ton-mile taxes than those imposed on domestic trucks. Examples of States in this group are Arizona, Kansas, Oklahoma, and Wyoming.[67]

Between these extremes are many States whose restrictions on licensing of out-of-State trucks are typically very rigid but subject to considerable liberalization through special reciprocity agreements with certain States. States in this group include Florida, Minnesota, and Virginia.

Beginning in 1931, the tightening restrictions on highway travel by busses and trucks and the growing need for State revenue led to pressure for registration of such vehicles in each State in which they operated. As a result, motor vehicle "border wars" broke out among the various States in 1931 and have continued intermittently, 13 being recorded in the following 6 years. To cite a single instance, "when Maine seized a New York truck driver * * * and forced him to pay a license fee of $75 on his truck, New York retaliated by holding two Maine truck drivers for not having New York license plates."[68]

Since 1937 there has been a lull in these wars, chiefly because of the growing use of reciprocity agreements among the States. Testifying in March 1940, before the Temporary National Economic Committee, A. H. Martin, Director of the Marketing Laws Survey, stated that while reciprocity in one form or another was provided in the laws of some 41 States, only 9 States granted complete reciprocity as to all fees.[69]

The laws of Nebraska are cited as a typical example of the effect of reciprocal agreements. Under its reciprocity laws, trucks of other States were exempt from Nebraska license fees provided similar privileges were extended to Nebraska trucks. Similar provisions applied to the ton-mile tax, license plates, and other special taxes. Only 18 States cooperated with Nebraska fully enough to permit trucks from these States to pass through Nebraska without purchasing a license. As for trucks from the other 30 States, the requirements of Nebraska

[65] Temporary National Economic Committee, Interstate Trade Barriers, p. 15790.
[66] Barriers to Internal Trade in Farm Products, p. 39.
[67] Ibid.
[68] Ibid., p. 41.
[69] Temporary National Economic Committee, Interstate Trade Barriers, pp. 15790–15791.

varied with the requirements which each State imposed on Nebraska trucks. Four States—Arizona, California, Mississippi, and New Mexico—required all out-of-State trucks operating for any purpose to register therein, with the result that Nebraska required all trucks coming from these States to comply with its registration provisions. Other States—for example, Kentucky, Minnesota, Montana, Oregon, Texas, and Washington—required out-of-State trucks that operated for hire to purchase a license. Therefore, Nebraska required trucks from these States to purchase a license in Nebraska.

(*b*) *Highway use regulations as a trade barrier.*

Although not directly a tax problem, it should be mentioned here that a second set of interstate conflicts arises from the 48 different methods of regulating highway use in the States. These regulations often are enforced in connection with registration and hence are indirectly associated with the tax problem. Under their police powers the States can virtually set up whatever regulations they please regarding use of highways so long as they do not discriminate between intrastate and interstate operators. In exercising this authority the States have set up operating rules to be observed by highway users and regulations relative to permissible sizes, weights, and types of vehicles. As a result, it is sometimes extremely difficult, if not impossible, for highway users licensed in one State to qualify for registration in another. For example, in 1941, maximum length of trucks varied from 30 feet in Kentucky to 85 feet in 4 States, while Maryland and Massachusetts had no limits at all. Obviously a 100-foot trailer-truck from Massachusetts could not even move on Kentucky highways. The maximum gross weight permitted by the different States varied from 18,000 pounds in Kentucky and Tennessee to 120,000 pounds in Rhode Island.

These regulations are not entirely without reason. For example, Kentucky has defended its low weight and length regulations as a reasonable and proper exercise of the police power of the State for the purpose of preserving the public highways and providing for the public safety. Its highways, owing to mountainous topography, have an abnormally large number of grades, curves, and restricted-driving areas. Furthermore, a large number of its bridges are substandard, either as to width, height, or load capacity.

(*c*) *Multiple taxation through changes in residence.*

As was previously mentioned, the problems of multiple taxation of motor vehicles and their operators arising from bona fide changes in State of residence are closely akin to the difficulties of multiple taxation encountered by trucks and commercial carriers engaged in interstate commerce. Many States require a vehicle owner moving into the State not only to buy new registration tags, but also to pay the registration tax for all or part of the State's registration year (without allowances for similar taxes paid in other States), obtain a new motor-vehicle title, for which a varying fee is charged (sometimes accompanied by title taxes as, for example, the Maryland 2-percent title tax on the market value of vehicles first registered in that State), buy new drivers' licenses for himself and other members of the family (in some States an individual must buy drivers' licenses good for 3-year periods), and perhaps pay a State and local property tax.

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Thus, if an automobile owner duly registered and qualified for driving in the District of Columbia moves into nearby Maryland, he must purchase a Maryland title, pay the 2-percent titling tax, buy new Maryland registration tags, new drivers' licenses, etc. To complicate the picture further, if the same individual moved into Virginia a short time later, he would have to conform to the Virginia requirements. The result is that the owner pays three sets of taxes, fees, and charges as a result of his changes of residence, even though he may have continued to obtain his income from a job in the District of Columbia. The inequity of the situation is readily apparent.

While this problem has been an important one in the past, it has become more serious in the present emergency. In order to meet the demands of the war effort, it has been and will be necessary to transfer millions of industrial workers from peacetime to war industries. It is a safe assumption that a significant proportion of these persons have changed or will change their State of residence. At any rate, they will need to be increasingly mobile, and every impediment to their free movement should be surveyed from the viewpoint of its effect on the war effort.

5. REMEDIES FOR TRADE BARRIERS

In designing remedies for the intricate problem of interstate trade barriers, one must start with the obvious fact that many of the State restrictions and incidental regulations are desirable and are based on sound judgment. No one will deny the need for many of the trade regulations that have been promulgated by the States. For example, milk regulations have helped to protect the American consumer from contaminated milk and from unethical and fraudulent practices. No one will deny the need for regulating traffic on our highways in the interest of public safety. The real damage occurs when these measures interfere with interstate trade to a greater extent than is necessary or desirable, when these regulations and measures are used to erect barriers against competitors, and when the sheer multiplicity and complexity of these regulations unintentionally hamper trade. It is extremely difficult to draw the line where the beneficial effects of State regulation end and the undesirable restriction on interstate trade begins.

It should also be clearly understood that the objective of free interstate trade is not synonymous with "unrestricted" trade. The elimination of all State and Federal laws on the subject of marketing would not necessarily promote free trade. On the contrary, it is very possible that their elimination would destroy a large part of the interstate trade that now exists. The freest possible trade can occur only when the farmer, the laborer, the manufacturer, the dealer, the retailer, and the consumer are protected by sound laws which are enforced honestly and impartially, regardless of the State of origin or destination of the products, persons, or services.

(*a*) *Court action not adequate.*

Among the remedies for trade barriers that have been considered, that of court action seems to offer small prospects. The courts are loath to impute an intent to discriminate in cases where State action, on its face, is not discriminatory. The courts, quite properly, view the problem as one for legislators and others who influence and determine legislative policy to solve. Thus, Justice Hughes in *McGoldrick v. Berwind-White Coal Mining Company* expressed this view and paid his respects to coordination of taxes as follows: [70]

Doubtless much can be said as to the desirability of a comprehensive system of taxation through the cooperation of the Union and the States so as to avoid the differentiations which beset the application of a commerce clause and thus to protect both State and National Governments by a just and general scheme for raising revenues. However important such a policy may be, it is not a matter for this Court.

A dissenting opinion in the case of *McCarroll v. Dixie Greyhound Lines, Inc.* (Justices Frankfurter, Douglas, and Black) expresses the same general viewpoint: [71]

Spasmodic and unrelated instances of litigation cannot afford an adequate basis for the creation of integrated national rules which alone can afford that full protection of interstate commerce intended by the Constitution. We would, therefore, leave the questions raised by the Arkansas tax for consideration of Congress in a nation-wide survey of the constantly increasing barriers to trade among the States. Congress alone can, in the exercise of its plenary constitutional control over interstate commerce, not only consider whether such a tax as now under scrutiny is consistent with the best interest of our national economy, but can also, on the basis of a full exploration of the many aspects of a complicated problem devise a national policy fair alike to the States and our Union.

(*b*) *Removing motor vehicle barriers.*

While a number of solutions of the trade-barrier problem as it relates to trucks and busses have been suggested, increased efforts to promote reciprocity and cooperation appear to be the soundest program. Considerable progress is now being made in certain parts of the country in the extension of reciprocity tax agreements. Michigan has recently worked out a reciprocal agreement with Indiana, Illinois, and Ohio. In the far West at least six adjoining States have entered into fairly liberal bilateral reciprocity agreements. If this movement could be extended to cover the entire country the trade-barrier problem created by taxing out-of-State trucks would be solved.

Some progress is also being made toward uniformity of regulatory requirements. The American Association of State Highway Officials has adopted and promoted a uniform regulation statute. These uniform specifications have been enacted into law in 18 States. In addition, a group of specifications promulgated by the Western State Highway Officials Association has also received considerable State following.

More recently, as a result of conferences between representatives of the States and of the Federal Government, there is now a nation-wide acceptance of a ceiling over maximum truck and bus regulations. The movement for the elimination of State impediments to the war effort was initiated at the Federal-State Conference on War Restrictions called by President Roosevelt and held in Washington, May 5 to 7, 1942. Following the conference a committee was appointed to consider the motor-vehicle trade-barrier problem. The committee met with the executive committee of the Governors' Conference. It was agreed that uniform standards for motor transportation, developed by a number of States in cooperation with the Public Roads Administration and approved by the War Department, were satisfactory standards for the duration of the emergency. By June 1,

[70] 309 U. S. 69 (1939).
[71] 309 U. S. 176, 189 (1939).

1942, the States had all accepted the program. Unfortunately, it included no understanding regarding truck and bus registration taxes.

Federal interference as to regulation is probably well within the powers of the Interstate Commerce Commission. If exclusive Federal control in this field is thought necessary, it is a relatively simple matter to establish such control. Where State regulation is judged by Congress to interfere unduly with interstate traffic, the Federal Government can assert exclusive jurisdiction.

For tax barriers, the problem is entirely different and much more complicated. States have the sovereign right to tax out-of-State vehicles for the use of highways in the taxing State. The States could perhaps be "bought out" of the field by the imposition of a Federal tax distributed to the States on condition that the latter confine their direct taxation of motor vehicles to those of resident operators. This solution would be cumbersome and difficult to implement. It would, in addition, relieve the interstate truckers of only part of their discriminatory burden. A program of this sort could be recommended only as a last resort.

A solution of the problem of excessive motor-vehicle taxation resulting from change by the motorist of his State of residence is even more difficult. Again it can be recommended that States extend their reciprocity agreements to cover this situation.

However desirable such a plan might appear to the layman, one of the most serious obstacles to its inauguration is the difference in fees and taxes that now exist among the States. The States hesitate to act on the ground that motor-vehicle owners will tend to register their cars in low-license-fee States, and then either obtain registration tags without added cost in the high-license-fee States or drive therein unmolested during the remainder of the registration year. This tendency might be avoided effectively by (1) requiring persons changing their State of residence to purchase new registration plates, and (2) crediting them with payments made on their old registration plates. To illustrate, a resident of Louisiana whose motor-vehicle registration tax is $3 moves to the District of Columbia where the annual registration fee is $5. The second set of registration tags would be obtained in the District of Columbia for $2. A similar arrangement could be worked out for drivers' licenses, except that the new State of residence might require the registrant from another State to demonstrate proper driving qualifications before obtaining a driver's license. As to the title tax, of which Maryland's law is one of the few examples, the States should provide for (1) the deduction of similar taxes paid in the former State of residence; and (2) the exemption of vehicles registered in other States for a minimum length of time—for example, 3 months.

(c) *Interstate cooperation.*

Trade barriers in general would seem to be a first-rate subject for interstate cooperation, and the States, under the leadership of the Council of State Governments, have made some progress with this approach. Aside from reciprocal legislation, with which an effective attack has been made in the case of license fees on foreign-owned trucks, discussed above, the principal weapon of attack is education. Trade barriers tend to cause ill will and retaliation among the States and a better spirit engendered by conference is likely to make for a mitigation of State commercial warfare. General knowledge of the facts about trade barriers would also be conducive, probably, to the removal of these impediments. For instance, it is claimed by the opponents of oleomargarine taxes that such taxes do not add materially to the demand for butter. Consumers who cannot afford butter turn from oleomargarine to other butter substitutes when the former becomes unavailable. If this be true, it should be subject to demonstration, and the evidence of such demonstration would have more effect on the attitude of dairy farmers than much exhortation against trade barriers.

(*d*) *Federal-State cooperation.*

Finally, it is generally agreed that trade barriers are a subject par excellence for Federal-State cooperation. This is not to be confused with direct Federal action to eliminate trade barriers for which, perhaps, neither the will nor the power to act exists. In the case of oleomargarine taxes, for instance, not much hope would seem to lie in congressional action in view of the fact that Congress itself has imposed a tax on oleomargarine, probably not exclusively for revenue. Several Federal Departments, including those of Agriculture, Labor, and Commerce, have manifested a strong interest in the field, and have shown all possible willingness to cooperate in any program to reduce the scope of barriers. New implementation for this Federal-State cooperation was suggested by Frank Bane, representing the Council of State Governments, in his testimony on trade barriers before the Temporary National Economic Committee. He recommended a Federal-State commission to deal with the field, the commission to be composed of 12 members, with representation to be divided equally between Congress, the executive branch of the Federal Government, and the States represented through the Council of State Governments. Bane expressed the hope that the commission would cover a field somewhat broader than trade barriers:

> It would be our hope that such a committee, if established, would not confine itself exclusively to this one problem, but, in cooperation with the Council of State Governments and other interested organizations, would explore other major questions of Federal-State relationships so pertinent to the effective operation of our government—problems arising from conflicting and overlapping tax laws, grants-in-aid and their effect upon education, highways, health, and welfare, as well as general State and Federal services, the development and coordination of our various systems of transportation, and problems of personnel inherent in the Federal, State, and local cooperative government which we have developed.[72]

Bane's proposal was seconded by Henry Wallace, then Secretary of Agriculture, in a letter to the Temporary National Economic Committee in which he stated: "This Department heartily approves of Mr. Bane's suggestion. We believe that a committee of this kind could study in detail several of the specific trade barriers in agriculture and could be very helpful in working out practical programs on which the Federal and State Governments could cooperate." [73]

The Canadian Royal Commission on Dominion-Provincial Relations expressed the view that "interprovincial discrimination in Canada appears to be considerably less dangerous than interstate discrimination in the United States." The Commission added, however, that such discrimination had already become serious "and American

[72] Testimony of Frank Bane, executive director, Council of State Governments, Chicago, Temporary National Economic Committee, Interstate Trade Barriers, p. 15751.

[73] Letter from Henry A. Wallace, Secretary of Agriculture, to Temporary National Economic Committee, in Interstate Trade Barriers, p. 16114.

experience shows that it may become much worse." Several remedies are considered in the report; one that seemed to the Commission and to the present authors as quite promising called for a tribunal to pass upon alleged trade barriers. The Commission expressed the view that "it is probably not desirable that the decision of such a tribunal should be mandatory in the sense of invalidating legislation found to be unduly discriminatory." The prestige of the tribunal's findings was thought sufficient to prevent and correct the abuses.[74] The view was expressed that the precise form of reviewing machinery should be a matter of agreement at a Provincial-Dominion conference but as to principles it was stated quite vigorously that:

> There should, we think, be complete freedom of trade and commerce throughout Canada; complete freedom of investment; complete freedom of movement and freedom from arbitrary restrictions (as distinct from a bona fide test of vocational qualifications) in the practice of a trade or profession; and complete freedom from discriminatory taxation.[75]

(*e*) *Conclusion.*

Here in another field we see the importance of new implementation, some machinery for intergovernmental negotiation, education, research, to make the complicated structure of our governmental machinery work more smoothly and effectively. Two alternatives seem to present themselves: Federalization, or more active, better implemented Federal-State cooperation. The latter, of course, contemplates the preservation of the States and the maintenance, perhaps the strengthening, of their status as partners in the program. To say the least, it is distinctly worth trying.

[74] Report of the Royal Commission on Dominion-Provincial Relations, book II, p. 66.
[75] Ibid., p. 67.

CHAPTER IV

PROBLEMS OF FEDERAL-STATE-LOCAL RELATIONS

A. The Taxation of Government Instrumentalities

1. IMMUNITIES AND PAYMENTS IN LIEU OF TAXES [1]

(a) *Introduction.*

Federal fiscal responsibility to local governments because of the ownership of Federal properties within the boundaries of such local governments presents one of the more difficult and less satisfactorily handled problems in Federal-State-local fiscal relations. One needs only to contemplate the loss to the States which would arise were the Federal Government to take over the railroads to appreciate how large and vital this problem might readily become. It is not a new problem but one that has been aggravated by the war program. The Federal Government has acquired large amounts of property for reservations including cantonments, artillery ranges, airfields, arsenals, transit facilities, ammunition depots and the like. In addition, the armed forces and the Reconstruction Finance Corporation have acquired war plants, and other Federal agencies have developed extensive defense housing projects. Local finances are affected by these developments, both because of the depletion of the local tax base and because the Federal property in most instances requires varying amounts of local servicing. On the other hand, in some cases the location of Federal property has probably added indirectly to the tax base more than enough to compensate for the additional services involved.

Federal payments in lieu of taxes have been on a more or less opportunistic basis for many years, and arrangements have differed with different Federal projects. Differences of procedure have occurred even within the same class of property in the charge of the same Federal agency.

Local dissatisfaction with payments in lieu of taxes was already in evidence even before the war era. It was alleged that the arrangements concentrated an undue burden on taxable real estate and that the payment plans were inflexible, undependable, and discriminatory. These complaints are now more emphatic than before. Those opposing the discontinuance of the issue of tax-exempt securities by State and local governments have made a major point of the extent of tax-exempt Federal property, holding that costs of local functions and debt service would be increased at the same time that Federal activity is reducing tax bases. Unless something is done to improve the strained Federal-local relations concerning payments in lieu, valuable programs such as those in the field of housing may be imperiled.

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[1] Based mainly on a monograph prepared for this study: Russell J. Hinckley, Compensation to States and Localities on Federally Owned Tax-Exempt Real Estate.

(*b*) *New implementation desirable.*

More important by far than any rigid set of rules and principles for guidance in determining payments in lieu is the development of some machinery whereby rules can be inaugurated, revised, and effectively used as criteria for new legislation. There should be some agency responsible for the regular promulgation and revision of rules and principles in this field, to which all legislation involving payments in lieu might be referred for criticism. In other words, what is needed is a clearing house for payments-in-lieu proposals. This agency should have the mandate to consult and confer with all interested parties. An agency of the sort suggested could also play a useful role in hearing complaints—particularly local complaints concerning in-lieu payments. A Federal-State Fiscal Authority could function most effectively in these two roles.

A better correlation of programs for payments in lieu of taxes might also be promoted were Congress to establish a special joint committee (perhaps temporary) to consider the large volume of new legislative proposals which fall in the field.

(*c*) *Discussion of general principles and applications to general classes of property.*

It would be presumptuous for any group of persons with limited experience to attempt to state a set of principles applicable to all the myriad situations which call for judgments as to payments in lieu. Nevertheless a few generalizations can be offered:

1. It is more desirable to develop a consistent and intelligible policy in this field than to insure perfect balance of interests in specific situations.

2. Some recognition should be given to the benefit bestowed on a community by the location of a Federal function. The location of all functions, private and public, is usually beneficial, but it does not follow that they should be tax exempt. There may be exceptions, however, where Federal programs assume functions which might otherwise have to be performed by State or local public agencies such as public works projects or special improvements financed by special assessments. Flood control and reclamation projects are examples.

3. Property that has long been owned by the Government, and new properties of the same class, should ordinarily be exempt, with no compensation from Federal funds. The affairs of all concerned have long since been adjusted to the exemption status. No useful purpose would be served, for instance, by subjecting United States post-office property and general administrative buildings to local taxes. Extensive public-domain lands have never been taxed and probably should be placed in this category, also, although revenue-sharing devices of long standing will probably have to be retained. Also, where properties recently acquired, notably military areas, have caused sudden and serious local tax loss, payments covering the actual loss should probably be provided, although the properties are of the same order as those long owned and exempt.

4. Where services are sold by governmental agencies on a commercial basis and in competition with similar private activities, as in the power projects, the commercial element of the property involved should ordinarily be valued by the Federal Government with primary consideration to a capitalization of the income. The alternative of

payment on gross income may be preferable in some instances, particularly where comparable private taxes are based on gross income.

The case of low-rent housing differs in that a subsidy element is involved. Payments in lieu of taxes should be made on a contractual basis, taking into account the ability to pay of the families rehoused as reflected by the rentals charged in the project.

5. Other Federal property that is utilized ordinarily by private individuals, or designed for sale to private individuals, such as farm and resettlement properties or additional Indian lands, should pay the equivalent of levies on privately owned property. For this and other federally owned property on which in-lieu payments are made valuation should remain subject to Federal control.

6. Property for conservation projects (such as submarginal and cut-over forest lands) might well pay a low, flat, average rate on value as of the time of acquisition. This would constitute a minimum guaranty, pending larger local receipts from a distribution of revenue when the property becomes revenue-producing. The flat rate would represent a rough adjustment to average tax yields on this type of property. The percentage of revenue shared would resemble a severance tax. This plan is considered feasible, not only for ease of administration in the case of large holdings of low value, but also as an approximation of what is considered to be good property-tax practice on depleted lands.

7. Although, in the main, full local services should be supplied the Federal property and its residents, it is realized that there are cases in which the Federal agency is obliged to supply directly public services and facilities customarily financed out of local property-tax funds. The Federal agency may even make the facilities available to local residents. In these cases, there is room for adjustment of the payment to local units, particularly when the amount otherwise payable is the full equivalent of local taxes on land and improvements.

The above list represents an oversimplification of the problem, and is submitted with the hope of focusing attention on fundamental issues.

The entire field of Federal payments in lieu of taxes is surveyed in much more detail in the following pages.

(*d*) *Legal tax exemption of federally owned real estate and the problem of exclusive jurisdiction.*

The taxable status of Federal real estate is but one aspect of the complex legal problem of intergovernmental tax immunity. The entire subject has had a legal history which is bizarre and devious, but the legally tax-exempt status of real property owned by the United States and its instrumentalities, including corporations, has not been effectively challenged. There has been a tendency toward contraction in other phases of the intergovernmental tax immunity doctrine, although Congress still retains the power to determine the degree to which Federal activities as such shall be subject to State and local taxation. In recent cases, however, the Supreme Court seems disposed to require more definite evidence of a congressional intent to exempt certain activities from State and local taxation other than ad valorem taxes.[2]

[2] *Helvering* v. *Mountain Products Corp.* (303 U. S. 376 (1938)); *Graves* v. *N. Y. ex rel. O'Keefe* (306 U. S. 466 (1939)).

The Constitution does not specifically forbid State and local taxation of Federal instrumentalities, but immunity was originally declared in 1819 by the Supreme Court in the case of *McCulloch* v. *Maryland*.[3] This decision held (with reservations) that taxation by States of the instrumentalities of the Federal Government was an interference with the latter's sovereignty. If the States were allowed to impose their taxing powers on the exercise of powers granted to the Federal Government in the Constitution, it would be possible to prevent the proper use of such Federal powers. This decision, and many that followed it, declared State tax laws applied to Federal activity unconstitutional under the "constitutional theory" of immunity. This means that under the dual system of government prescribed by the Constitution, Federal instrumentalities were outside the territory and sovereignty of the States and that there was a total lack of right to tax them—an implied limitation on taxing power. At times, this doctrine has given way to a more modern concept of "legislative immunity" in accordance with which State taxing statutes are held inconsistent with Federal legislation and inoperative.[4]

There is no need to trace here the involved Supreme Court history of these doctrines in expanding the area of intergovernment immunity to include for a time public securities, public employees' salaries, and even public contractors' purchases, and then gradually narrowing the field with decisions establishing taxability of salaries of public employees,[5] and removing certain exemptions which had been invoked for purely private interests—not public instrumentalities as such.[6]

There is no legal precedent for State and local ad valorem taxation of federally owned property unless Congress has expressly conferred the right to tax. Neither has there been any distinction between proprietary and governmental activity for tax purposes as to the Federal Government, although such a distinction has been made in the case of the States.[7] The rule appears to be that the Federal activity is either constitutional, and cannot be taxed by States, or that it is unconstitutional. That is, all the agencies which Congress can constitutionally create are governmental agencies. Congress can, if it wishes, surrender exclusive authority over Federal property to the extent of consenting to its taxation, and a State may seize the property if it subsequently becomes tax delinquent. "If Congress in enacting legislation determines that a needful rule regarding certain property belonging to the United States is to permit such property to be subject to State taxation, so long as it is not taxed at a higher rate than other similar property and enacts a statute to that effect, its action in doing so would seem to be in accord with the Constitution." [8]

[3] 4 Wheat. 316 (U. S. 1819). A discriminatory Maryland tax on the Bank of the United States was at issue.

[4] Where Congress has refrained from exercising legislative power, and no intent is evident that the instrumentality be immune, the courts frequently fall back on the implied constitutional immunity doctrine.

[5] Now also provided for in the Public Salary Tax Act of 1939.

[6] Including the recent Alabama sales-tax cases permitting nondiscriminatory State sales taxation of defense contractors in the absence of specific congressional legislation to the contrary. *Alabama* v. *King and Boozer* (62 Sup. Ct. 47 (1941)); *Curry* v. *U. S.* (62 Sup. Ct. 48 (1941)).

[7] E. g., *South Carolina* v. *U. S.* (199 U. S. 437 (1905)) involving State liquor enterprises. Federally financed corporations are construed as tax exempt in that the property does not lose its public character merely because the Government takes title in the name of a corporation which it creates and controls for convenience and of which it owns all of the stock. Even if the corporation is somewhat separate, and the real estate is not directly owned by the United States, taxation is a burden on a Federal instrumentality.

[8] Opinion of Attorney General in: Federal Ownership of Real Estate and Its Bearing on State and Local Taxation, H. Doc. 111, 76th Cong., 1st sess., Jan. 16, 1939, p. 8. Congress has consented in certain instances to be mentioned later.

All this does not mean that hopes are not entertained in States and local quarters from time to time that a proper case for taxation, without consent, of Federal proprietary activities involving real estate, might be presented and sustained by the Court. These groups contend that there is nothing in the Constitution itself which suggests that in granting immunity to its instrumentalities, the Federal Government has any more power than a State to grant immunity to *its* instrumentalities and that the "necessary and proper" clause confers no such power upon Congress. So, the argument runs, the Federal Government should not be permitted to create immunities of its instrumentalities by legislative declarations which are broader than the constitutional immunity implied by the need to make the dual form of government function. The protection of both the States and the National Government from discrimination and interference should rest upon constitutional and not legislative grounds, and the so-called economic-burden test of interference should be applied to both branches of government. Nondiscriminatory taxes would not constitute an excessive burden on most of the proprietary and many other activities of either level of government. It is claimed that the Federal Government can engage, and is engaging, in activities and businesses only incidentally related to governmental functions and delegated powers, and that a sound legal rule should be that a Federal instrumentality is proprietary as long as its function is to supply commodities or services to the general public which are ordinarily supplied by private enterprise, and a direct or incidental profit is derived. It should then be taxable where the tax is patently nondiscriminatory and does not cause a direct or appreciable drain on Treasury funds.[9]

The argument that, under delegated Federal powers, Congress can create constitutionally only those agencies whose purposes are to carry out these delegated powers is held to be highly theoretical. It is pointed out that no decision has recently been rendered squarely on the question of State taxation of the property of Federal peacetime proprietary agencies [10] although the point has been raised.[11]

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[9] This general thesis was developed in State Taxation of Federal Agencies, S. Doc. 86, 75th Cong., 1st sess., 1937, pp. v–viii and 4152.

[10] The World War corporations engaged in building ships, lumber operations, housing, war finance, and regulation and sale of food were held exempt on the ground that they were necessary to prosecution of the war, hence governmental, and not conducted for business profit as such.

[11] There have been a number of instances of State and local attempts to subject federally owned real estate, and other property, to taxation. These have been abortive efforts, often designed for political effect, to call attention to the problem, to embarrass or bring pressure on the Federal agency, or to initiate court consideration of the exemption question as to some type of property. In Georgia, two laws were passed in 1939 authorizing the State and local units to tax Federal agencies or other States engaged in the generation, distribution, or sale of electricity, and to subject, except insofar as the Constitution and laws of the United States prohibit, all proprietary properties of Federal agencies and corporations organized under Federal law to taxes at the rate applied to private property (Acts and Resolutions of the Georgia Legislature, 1939, pt. I, title III, pp. 202–203). This was directed at the Tennessee Valley Authority which had seriously affected the tax base of Fannin County and which had made no contribution in lieu of taxes at the time to that county.

Hamilton County, Tenn., announced its intention to assess Tennessee Valley Authority personalty at $2,000,000, but dropped the matter when more adequate contributions in lieu of taxes were provided for under 1940 congressional legislation. The Alabama Legislature declared in 1939 that the property and activities of the United States and its agencies should be taxable, except when the State is without constitutional authority to impose such taxes (H. B. 57, Laws 1939, approved March 2, 1939). This law was not actually applied, but was intended to call attention to adverse effects of Tennessee Valley Authority property acquisition and to permit the State to tax the property should Congress later consent to taxation.

Many similarly futile declarations have been made in other States. Federal properties have been assessed, billed, and put up at tax sale, sometimes intentionally, sometimes in error. Local officials have sometimes refused to remove properties from the tolls and have endeavored to bill occupants of certain types of resettlement farm units. Efforts have also been made to tax the equity of persons purchasing Federal properties (especially resettlement farms) on long-term contract. (The experience of the Farm Security Administration with administration of payments in lieu of taxes on large holdings of resettlement properties affords numerous instances of these practices.) As long as the United States retains title as security for payment of part of the purchase money, or performance of other conditions, there is no evidence that the property itself is taxable or may be seized for taxes in the absence of consent.

A legal problem closely related to that of tax exemption of Federal property is the extremely confused one of jurisdiction. This involves the rendition of local public services to the property and its residents. If the United States retains exclusive jurisdiction over the land, residents of the property are legally nonresidents of the State and are not entitled to all the benefits or obligations of State citizenship. They are not, for example, entitled to free public-school services or the benefits of State poor laws, and may not sue for divorce in local courts. The right to vote depends upon the wording of State law, but there is usually no such right, and the local government is not obliged to supply roads, streets, police, fire protection, and other services. State criminal laws cease to apply and general civil laws of the original government remain in effect except insofar as inconsistent with the laws of the new jurisdiction, but laws adopted later by the original government, even if amendatory to old laws, have no effect.

By article I, section 8, clause 17, of the Constitution, Congress has exclusive jurisdiction over all places purchased with the consent of the State legislature for "forts, magazines, arsenals, dockyards, and other needful buildings." Many other properties appear to come within the "other needful buildings" clause, although the classification is often obscure. Exclusive jurisdiction is acquired in three ways:

1. By reservation at the time of the State's admission;
2. By condemnation or purchase with the consent of the State legislature for purposes enumerated in the Constitution; and
3. Passage of a State act ceding jurisdiction.

Some States have passed general acts of cession covering any Federal purpose, and in other cases the States have ceded land for specific projects or purposes, sometimes reserving certain jurisdictional rights such as the right to tax private property, business, and persons in the areas. Unless expressly indicated at the time of acquisition, the courts usually assume that both governments were intended by Congress to exercise concurrent jurisdiction. Therefore, unless a State has ceded jurisdiction, it retains jurisdiction over (1) those lands purchased by the Federal Government without the consent of the legislature; (2) those federally acquired by eminent domain unless this involved legislative consent; and (3) those acquired by the Federal Government in a territory which later became a State, provided the Federal Government did not retain exclusive jurisdiction when the Territory was admitted. The United States acquires exclusive jurisdiction in a large number of States—those which have consented to purchase of lands for purposes enumerated in the Constitution. Even if property is not included in the enumerated purposes, exclusive jurisdiction is acquired in about half of the States which have general acts of cession covering Federal purchase for any public purpose.

The United States can refuse exclusive jurisdiction if such status is not regarded as beneficial, and on many occasions Congress has expressly waived exclusive civil and criminal jurisdiction by special legislation, as in the case of national forests, housing and resettlement projects,[12] migratory bird refuges, and grazing districts. This has sometimes been stipulated in congressional acts, even though technically exclusive jurisdiction would not have been secured in many States without legislative consent. This action was taken to indicate clearly a desire that the residents be permitted all the rights and

[12] 30 Stat. L. 36 (1897); 16 U. S. C., sec. 480; 49 Stat. L. 2025, 2035 (1936).

privileges of State citizenship. This can be done for property owned by the United States in all places except the District of Columbia and the Territories, and is a more effective device than the adoption of assimilation crime statutes,[13] etc. The States cannot interfere with Federal use of such property in any event, hence exclusive jurisdiction is not essential, or even a convenience, and merely raises complicated problems for residents. There are a number of situations where it is not entirely clear what the status of residents is. In others, there is no doubt about exclusive Federal jurisdiction, and the State is not obliged to provide public services. Some States and local units have provided free educational and other services by law, others informally, while still others extend no services, or exact fees therefor. Even where the State clearly has civil jurisdiction and there is an obligation to provide public services, there is no assurance that the service will be provided, since that obligation does not require delivery of service at a particular time or place, or in any given quantity, and the plea of lack of funds can always be entered.[14] Where the Federal project has adverse fiscal effects on the local unit and requires costly services, there is commonly a tendency for local units to raise these points, if the jurisdiction argument itself is not pertinent, and even to attempt to question the constitutionality of acts of Congress authorizing purchases not strictly in line with traditional Federal functions.

Thus it may be said that, legally, there are two types of tax-exempt real property owned by the United States: (1) Tracts known as Federal reservations over which the Federal Government is sovereign and Congress has exclusive power to legislate under article I, section 8, clause 17, of the Constitution; and (2) lands to which the Federal Government has only proprietary title, the State retaining sovereignty and jurisdiction, in which case there is no doubt about the technical right of residents to vote and enjoy local services. In the latter category may be placed a number of housing, resettlement, corporate, and credit agency properties not used for "essential" governmental purposes, but for the benefit of individuals or groups in promotion of the general welfare. It is with respect to such property that Congress has been disposed on occasion to consent to taxation or authorize substantial payments in lieu of taxes.

(*e*) *The current significance of tax-exempt Federal real-estate holdings to Federal-State-local relations.*

(1) *Rapid increase in public land acquisitions.*—Federal real-estate holdings are so large and have been increasing so rapidly that their tax exemption has produced one of the major problems in Federal-State-local relations. Events of the past decade in particular have intensified the frictions. Unprecedented acquisition of taxable property by many Federal agencies has occurred at the same time that the property-tax system, upon which local government relies so heavily, was undergoing considerable strain brought on by increasing pressure for revenue, depression delinquencies, and resulting high rates. Extensive property-tax exemptions of other types have contributed to the problem. For these reasons many large Federal acquisitions have been bitterly opposed in many quarters within the local units affected.

[13] Providing that State criminal law is applicable.
[14] Cf. discussion by Philip M. Glick, "The Federal Subsistence Homesteads Program," Yale Law Journal, June 1935, pp. 1324-1379.

Over the past decade, a large increase occurred in the usual Federal holdings in connection with "normal" functions as department activities expanded. New post offices and administrative buildings were erected in considerable numbers. More important, however, were the activities of many new agencies, involving large and valuable holdings. These included many lending agencies and corporations engaging in quasi-business enterprise, the production of power, urban housing, and rural resettlement. Most significant was the expansion of conservation activity, which for the previous 25 years had involved only moderate programs of land purchase for forests and parks. Conservation aims were supplemented by the desire to provide employment in extensive development work. In fact, employment was a major factor in public-land acquisition and construction of all types during this period. In connection with regional development and reclamation plans, the national-forest and park-purchase programs were extended, millions of acres of submarginal land were acquired, flood-control acquisitions were increased, game refuges were multiplied, Indian reservations were enlarged, and power programs were initiated. To the activities mentioned, there are now being added important Federal acquisitions of taxable land for war purposes: Forts, camps, firing ranges, docks, airfields, housing, war plants, etc.

(2) *Federal-State-local conflicts.*—Protests from local units throughout the Nation have been many. The 11 western public-domain States in particular developed strong opposition to this trend of events. Not only were purchases of existing taxable property within their borders heavy, but these States already had large proportions of their area in tax-exempt public domain land. Withdrawal of public lands from entry and increased Federal conservational control of such lands was attacked as impairing the future growth of the tax base.[15] For many years, the public domain States had insisted that the broad constitutional authorization for Congress to dispose of the public lands was a virtual requirement that such lands be disposed of to private ownership (or the States) as rapidly as possible. They contended that, as long as large areas continued to be held by the Federal Government, they were not admitted to the Union on an equal footing with other States, and that their sovereignty was impaired by not being granted full control of the lands. The conservation programs therefore revived the demand that the public lands be ceded to the States, that they be disposed of to private taxable ownership, that they be admitted to taxation, or be covered by tax-equivalent payments in lieu of taxes.[16] Typical of the point of view widely held in the West with respect to the new purchase programs, was the following resolution adopted at the 1941 convention of the American National Livestock Association:

> Whereas the activity by Government agencies to acquire lands in the several Western States with destructive effects upon State tax structures has continued: Therefore be it
>
> *Resolved*, That no land located in any of the 11 public-land States shall be acquired by purchase, condemnation, or otherwise by the United States or any agency thereof, unless compensatory adjustment is made to such States to shield their tax structure.[17]

[15] Subcommittee of Senate Committee on Public Lands and Surveys, Hearings, 76th Cong., 1st sess., 1941, pursuant to S. Res. 241, pt. 2, Administration and Use of Public Lands.
[16] Ibid.
[17] Ibid., p. 311.

Other symptoms of friction in Federal-State-local relations, and the protests, demands, and claims of governmental units and special interest groups have taken many forms:

1. Individual local units and officials have protested to Congress and the Federal agencies, and resolutions and demands for compensation have been made by groups and associations of county and municipal officials.
2. State departments and commissions have given study to the Federal exemption problem, frequently in connection with such developments as the Tennessee Valley Authority.
3. As indicated previously, attempts have been made to subject certain properties to taxation by State legislation or local action, often merely for political effect.
4. Federal agencies have been obliged to devote considerable research attention to the fiscal effects of their programs upon local government when local opposition imperiled their programs.
5. Congress has taken a lively interest in the problem, as evidenced by extended hearings and discussions on the subject of payments in lieu of taxes as such, or in connection with appropriations for land acquisition and power projects. At least 30 bills pertaining to compensation to local government in lieu of taxes were introduced in each of the Seventy-sixth and Seventy-seventh Congresses. Such bills are often of special application to particular localities, certain projects, or certain types of projects.
6. Taxpayers associations have registered protests and made surveys. Individual property taxpayers have expressed concern over effects upon tax burdens, and resentment that certain groups (e. g., in the case of urban housing and resettlement farms), often in competition with themselves, should benefit from tax exemption as well as low interest rates and other privileges.
7. Holders of local bonds have opposed large purchases without annual compensation on the ground that the security of local obligations is endangered by reduction of the tax base. The remedy of higher rates and mandamus levies would induce a cycle of tax delinquency in extreme cases.
8. Special-interest groups have entered the controversy. Private real-estate associations, companies, and lending agencies have opposed the growth of Federal tax exemption in general and exempt housing in particular. Some of these same groups, however, have favored other types of property-tax exemption, such as those for homesteads and certain industries. Private power interests have consistently called attention to the lack of full payment of taxes by public power projects and have rallied support on this argument.
9. The exemption problem has been utilized locally for other purely political purposes, to arouse opposition to administration programs or to draw public attention to some individual champion of local government.
10. Attempts have been made to deny public services or full public services to exempt Federal properties and their occupants, often when the question of exclusive Federal jurisdiction is not involved. This has on occasion forced direct Federal provision of the public services, mandamus suits, contracts for services at exorbitant cost, or the passage of legislation for payment in lieu of taxes. On occasion, the Federal property has, in effect, been forced out of the local jurisdiction. In New Jersey, in 1941, the State legislature acted to exclude the area

of a Federal defense housing project from the jurisdiction of Clark Township in Union County. Industrial properties were located in nearby cities, and it was held that public costs were increased far in excess of any additions made to the tax base or any sums to be received in lieu of taxes.[18] All the suburban resettlement projects have been separately incorporated as towns, although not entirely for the reason of failure to receive such services as existing local units customarily provide. It is possible for local units to embarrass Federal programs materially by failure to render certain public services when the legal question of jurisdiction is not clear, and even when it is entirely clear. As pointed out previously, there is no obligation to provide particular services in a definite quantity, time, or place. A few cases are on record where residents of property not under exclusive Federal jurisdiction have brought suit and successfully compelled local units to provide educational services, even though no tax or other payments were received from the Federal property or its residents.

11. Attempts have been made to enjoin particular Federal projects involving land purchase, by legal action; other projects have been effectively prevented by petition, resolution, refusal to sell, or other strong expression of local opposition. The nature of the programs and the purposes of acquisition were often such that Federal condemnation proceedings were not appropriate or possible. It is doubtful, for example, whether eminent domain proceedings to acquire property for resettlement purposes would be construed as within the usual concept of "public purpose." In 1936, Franklin Township in New Jersey successfully enjoined construction of a suburban resettlement project, claiming considerable tax loss and public costs to be incurred. The court held that the township might so protect itself from injury as a governing body, and that it had sufficient interest for an injunction suit in any court. The question of Federal power to purchase land for resettlement use was not ruled upon, although the court gratuitously expressed its belief that the terms of the enabling act were an unconstitutional delegation of powers to the President.[19]

12. Tax exemption of Federal property has been involved in other aspects of the dispute seething around intergovernmental immunity. Those State and municipal officers and others opposing Federal taxation of income from State and local securities have cited the net loss to State and local governments thereby and the sizable additional losses now endured by reason of tax-exempt Federal real estate and other property and enterprises.[20] Some have claimed that full taxability of Federal real estate would be an appropriate offsetting concession for Federal taxation of the State and local bonds.

(3) *Benefits versus costs.*—The contradictions inherent in many of the local situations are amazing. Local units and their citizens have earnestly sought the location of some Federal land conservation and other projects involving purchase of real property, often in full knowledge of their exempt status; yet upon completion of development work they have protested the tax loss. In the defense period, some local units have attracted private enterprise with offers of tax

[18] House Committee on Public Buildings and Grounds, Hearings, H. R. 5211, 77th Cong., 1st sess., 1941, pp. 169-179.

[19] *Franklin Township v. R. G. Tugwell, et al.* (85 Fed. 2d. 208 (1936)). Similar action was threatened elsewhere, but a bill authorizing payments in lieu of taxes was soon enacted to cover resettlement projects.

[20] C. H. Chatters, "The Case Against Taxation of Governmental Securities," Annals of the American Academy of Political and Social Science, March 1941, p. 77.

exemption, yet defense housing projects to house the workers are objected to because of tax exemption or inadequate payments in lieu of taxes. Not infrequently, the same local units have received substantial Federal loans and grants to assist in meeting the costs of defense public works. A county may have sought the low power rates of Tennessee Valley Authority and other benefits of the project, yet it is loud in its clamor for tax replacement. One group of cattlemen opposes Federal ownership of grazing lands and failure to pay taxes, while another association fears that if such payments are made, grazing fees for their use of public lands will be increased. Even where the Federal agency has paid the full equivalent of taxes on valuable land and improvements, local units have on occasion demanded further contributions on more liberal bases of per capita cost, etc. Some have set up claim for reimbursement of both tax loss by purchase and the public costs incurred.

The common argument is that a tax-equivalent payment, including that for improvements, does not equal the public costs of benefit to the Federal project and that the per capita valuation of the project does not equal the per capita valuation of the local district. This, of course, ingores the fact that the district valuation may include railroad and utility property, and that the district receives State aid and other revenues. In private ownership, the district would receive no more from the property.

In addition to such direct benefits as payment of all delinquent taxes, as a prerequisite to vesting of title in the Federal Government, and indirect commercial and economic benefits through stabilization of land use, etc., the Federal program may involve construction and maintenance of roads and trails, general forest-fire protection, and the building of schools or other public facilities, which would ordinarily be financed out of local funds. While it is not strictly reasonable to attempt to offset general Federal grants-in-aid against local tax losses and costs, Federal expenditures such as those mentioned, as well as tuition and other fees paid for services, are often legitimate offsets, and are frequently made in contemplation of exempt status. Federal highway aids have for some time contained adjustments for added benefit to the public-land States which complain of tax exemption of such lands. It is such situations that appear to warrant continued weighing of benefits and costs, however contentious a subject it may be, and not paying full equivalent of taxes in all cases, even if the Federal property is revenue-producing.

(4) *Extent of public holdings.*—It was in recognition of this complex state of affairs that a special committee was appointed by the President to report on Federal ownership of real estate and its bearing on State and local taxation. This committee was composed of the Secretary of the Treasury, the Acting Director of the Budget, and the Attorney General. Its report was chiefly an attempt to estimate the extent of public real-estate holdings and potential local tax losses. As of June 30, 1937, it was estimated that total Federal real-estate holdings (including public domain) were 395,000,000 acres, or 20.7 percent of the total area of the country. Cost of land and improvements was placed at $6,184,000,000, fair market value at $4,697,-000,000, and estimated assessed value at $3,283,000,000. Exclusive

of the District of Columbia, the latter figure was $2,579,000,000. The bulk of the land (366,000,000 acres) consisted of public domain. Only 29,000,000 acres had been acquired by purchase, donation, etc. Of this latter total, 47,444 acres were valuable urban-real estate.[21]

In the Rocky Mountain States, over one-half of the land was federally owned and in the Pacific Coast States, over 40 percent. In no other section was as much as 5 percent of the land owned by the Federal Government, although land was held in 2,965 cities and 2,628 of the 3,071 counties. The estimated assessed valuation of all the Federal property was only 2.9 percent of the assessed value all of *taxable* real property in the Nation. If taxable at local rates of as June 30, 1937, the property would have yielded $91,000,000.[22]

Under such a computation, the District of Columbia would receive $11,000,000; New York and its local units, $9,000,000; California, $6,000,000; Arizona, $5,000,000; and Delaware as little as $78,000. The relatively less populous States (chiefly the public-land States) showed the largest area of Federal property relative to total area and also tended to have larger ratios of estimated assessed value of Federal real estate to total taxable real estate, although this latter tendency was less pronounced, owing to low values of much of the public land. Arizona had 63 percent of acreage federally owned; Nevada 83 percent, while the ratios of assessed valuation of Federal to all taxable real estate were 74 percent and 76 percent, respectively.[23]

The estimates as a whole must be regarded as very crude and subject to many errors. No uniform methods of valuation were used by the different reporting Federal agencies and obviously dissimilar points of view were taken with respect to valuing Federal improvements. However, no other comparable figures are available from Federal sources, and the States have made no serious attempt to inventory such property. Since these estimates were made, a vast amount of property has been acquired for defense and other purposes. The Real Estate Section of the Public Buildings Administration is attempting to bring the record up to date, but encounters difficulties in reporting and other matters.

According to one writer, the 1937 estimated assessed valuation of Federal real estate represented only 16 percent of the estimated assessed valuation of all exempt real estate, Federal, State, local, and private (total $20,250,000,000).[24] Of course, it is the concentration of Federal holdings in particular local areas that is the source of complaint, but the small *relative* amount of total exempt Federal property would suggest the thought that many local units might well look to the large gradual accumulation of other exemptions as an important cause of the impaired tax base.[25]

It is recommended that the Federal Government provide the facilities for a continuing inventory of public property. This is desirable not only for its own sake but also to facilitate the development of balance sheet accounting for the Government.

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[21] Federal Ownership of Real Estate and Its Bearing on State and Local Taxation, H. Doc. 111, 76th Cong., 1st sess., January 16, 1939, appendix A, following p. 12.

[22] This is at a rate of $27.735 per $1,000 on assessed value; $1.91 per $100 on book value. Ibid., appendix A.

[23] Oregon had 46 percent of acreage and 11 percent of taxable assessed valuation federally owned; the District of Columbia, 23 percent of acreage and 60 percent of taxable assessed valuation.

[24] C. B. Pond, "The Value and Importance of Exempt Real Estate in the United States," Taxes, July 1940, p. 422.

[25] Such exemptions include: Homesteads; industries; State and local property; institutions and other private eleemosynary properties; veterans' property; and property exemptions because of payment of other taxes (motor vehicle licenses, utility taxes, etc.).

(5) *The Federal Real Estate Board.*—Following the report of his special committee, the President, by Executive order, established the Federal Real Estate Board.[26]

> The Federal Real Estate Board shall study and make appropriate recommendations regarding the situation in different communities adversely affected by the loss of tax revenue on land purchased or acquired by the Federal Government.

The Board was also to consider the question of disposal of surplus property. It is composed of representatives of various land-owning and administering departments. No staff is employed, except as each representative may draw upon the experience of his own agency. The Board has been studying payments to State and local governments on tax-exempt Federal property, and a report is expected in the near future. An early draft of the Board's report was made available to the Committee on Intergovernmental Fiscal Relations. The discussion in this and the succeeding section benefited materially from the observations in that report.

(6) *No single solution available.*—Examination of the problem of payments to State and local governments on Federal real estate does not readily reveal any thoroughly equitable principles for general application nor any new methods of equating benefits to costs. The problem is part of the broader one of intergovernmental fiscal relations and involves appraisal of the rights, duties, functions, and responsibilities of the three branches of government, Federal, State, and local, with respect to each major activity concerned. For this reason, it might well be a fit subject for the deliberations of any continuing Federal-State Fiscal Authority which may be established.

(f) General types of payments now made on Federal real estate.

Federally owned real estate covers an amazing range of types and uses of property. Some of the properties are productive of revenue, while others must be maintained entirely at public cost. Some were once privately owned and taxable, while others were included in the public domain and never subject to assessment. Certain ones may be considered as used entirely or partially in competition with private enterprise, some are used by private individuals for their support (resettlement farms) or economic activity (grazing lands), and still others implement regular governmental functions of long standing. A portion of the property is held pending sale to others, as in the case of surplus Government property and property acquired in settlement of debts to the United States, parcels foreclosed by Federal lending agencies, or items being sold under long-term purchase contracts. A few areas are leased for long terms to State and local public agencies for management. By far the largest holdings are intended for permanent ownership. It is not surprising, therefore, that a number of different devices have been created whereby payments are made by the Federal Government to States and local units on account of exempt real estate. The laws represent the accumulation of years; most of them have been framed to meet the situation and pressures of the moment; and no uniform or consistent set of principles or policies is apparent. Expediency and compromise have been the rule. Not even all lands of the same category are covered by payment plans.

In general, three types of payment have been made:

1. Real properties held by most Federal lending agencies, including some Federal corporations, have been subjected by congressional

[26] Executive Order 8034, par. 5, January 14, 1939.

consent to State and local ad valorem taxation. The Inland Waterways Corporation is the only noncredit agency in this group. In a few cases, personalty has also been included. The real properties involved are principally those acquired as a result of foreclosure in lending operations, and it seems reasonable that they should be retained on the tax rolls during temporary Federal holding.

2. Payment is made to States or local governments of a stated percentage of gross or net revenues from the use of land, with or without stipulation of the purposes for which the recipient may spend the funds. This type of provision is found in the case of certain acquired and public domain lands. Illustrative are the national forests and grazing and mineral lands, from the use of which the United States derives revenue, either by its own operations, or from leasing and sale of rights for use to other parties. The percentages are not uniform, ranging from 5 to 50 percent, and were apparently quite arbitrarily determined, with no necessary relation to local public costs or tax losses. Since the payments do not appear to involve a direct drain on the Treasury, rough justice apparently dictated that a liberal share of proceeds be distributed to the States, particularly those in which there were large areas of public domain with respect to which complaints had long been made. The practice has also extended to certain acquired lands, of course, as a partial compensation for actual tax loss, or potential tax loss for properties that might have been developed privately.

3. Authorization is given administrative agencies to make payments in lieu of taxes out of revenue receipts, appropriations, or both. Sometimes the authorization or practice is to make tax-equivalent payments on the original assessed value of the property; the assessed value of land only, or a valuation of the present improved property. Sometimes a mandatory or discretionary provision that consideration be given to costs of local public services rendered or Federal benefits conferred, is added.

On occasion, the tax-equivalent payment is stated as the maximum that may be paid. This type of payment has been employed in the case of valuable resettlement properties and certain peacetime and defense-housing projects requiring expensive local services.

There are, of course, related payments in kind, such as direct expenditures of a portion of forest revenues for roads and trails in counties and certain payments of tuition or other public service fees, by or on behalf of occupants of Federal reservations and Indians, but these are not always directly related to the holdings of exempt property.

Some of the payments, therefore, are based on property, some on revenues, and some on cost of service; some are made to States and others to counties; some are designated for special uses, others left for free revenue. The tendency has been to limit payments to agencies producing revenue by their operations, or which have elements of competition with private enterprise, but not all revenue-producing agencies make payments. On the whole, the exempt status of Federal property has been carefully guarded,[27] but Congress has shown a gradually increasing tendency to liberality in making compensatory payments and in recognizing responsibility to local units for tax losses on certain classes of property.

[27] From justifiable fear of excesses if property were freely opened to local taxation. England makes payment in lieu of taxes on Crown property at local rates, but has control over local units not possessed by our Federal Government.

No reliable figures are available on all payments made to States and localities under the various laws. For 1941, they may be conservatively estimated at $8,500,000. This would include all shared revenues from acquired and public domain lands, taxes paid directly by credit agencies and payments in lieu of taxes. It would include payments in kind from expenditures of a portion of revenues on national forest roads and trails. Excluded would be taxes on Reconstruction Finance Corporation war plants, lump-sum payments to the District of Columbia, payments in lieu of taxes on defense housing projects, and special service charges not related to property exemption per se (such as some $1,000,000 paid as school tuition for Indian children). The defense properties were hardly eligible for full payment in 1914, but will involve sizable distributions in 1942. Such payments might well double the estimate given.

Shared revenue payments to States and localities, 1941 [1]

1. Federal Power Act	$20, 000
2. National forests fund	1, 433, 000
3. National forest fund, special school lands, Arizona and New Mexico	23, 000
4. National forests, roads and trails	459, 000
5. Submarginal lands	32, 000
6. Oil and gas royalties to Oklahoma, south half Red River	10, 000
7. Oregon & California R. R. grant lands	558, 000
8. Coos Bay Wagon Road grant lands	35, 000
9. Sales of public lands	9, 000
10. Taylor grazing lands	89, 000
11. Migratory Bird Conservation Act	11, 000
12. Mineral Leasing Act	1, 946, 000
13. Potash royalties	142, 000
Total	4, 767, 000

[1] U. S. Treasury, Combined Statement of Receipts, Expenditures, and Balances for the United States for the fiscal year ending June 30, 1941, p. 713.

This total might well be adjusted to $5,230,000 to represent a more normal volume of distributions of Taylor Grazing Act funds and a larger actual distribution of mineral leasing and other receipts by the General Land Office.

To this sum would be added:

1941 payments in lieu of taxes: [1]	
War Department flood control lands	$6, 500
Tennessee Valley Authority	1, 500, 000
Boulder Dam (per statute)	600, 000
Farm Security Administration	750, 000
U. S. Housing Authority	[2] 60, 000
1941 taxes paid by—	
Credit agencies	[3] 350, 000
Inland Waterways Corporation	12, 700
Total	3, 279, 200

[1] These sums are estimates from various sources and agencies, including the Federal Real Estate Board.
[2] Not including new defense projects or payments made by local public authorities on properties leased from the United States and for which deductions are made in payments to the United States.
[3] Properties estimated at $18,000,000 multiplied by the average tax rate of $1.94 per $100 on book value.

The provisions of each of the statutes discussed here in general terms will be outlined in subsequent sections. There follows a classification and description of Federal real-estate holdings; a statement of present practices and complaints by type of property; an analysis of the elements of the problem in each case; and some suggestions for solutions. As previously indicated, the subject is one that requires constant study for more permanent and final answers.

(g) *Compensation to States and local governments on various types of federally owned real estate.*

The problem of payments to State and local governments on tax-exempt Federal real property may be conveniently analyzed under a classification of holdings according to functional uses. Ten major categories are established and arranged in an order that progresses from use of property for general Federal administration and performance of traditional Federal governmental functions, to the use of property, under recent extension of the general welfare concept, more or less by, or for the benefit of, selected private individuals.[28] In the intermediate stage are those properties that involve broad public purposes of comparatively long standing, but that may also involve incidental private use of the property or commercial sale of services to individuals. The first extreme would include post offices, forts, camps, dockyards, courthouses, and public office buildings. The other extreme would cover urban housing and farm lands. The intermediate stages would include the national forests, public grazing lands, power and water-control projects, and embrace both public domain lands and lands acquired from private ownership.

(1) *The seat of government—District of Columbia.*—The Federal Government owns approximately 29 percent of the land area of the District and about one-third of the value of all real estate, taxable and tax exempt. Properties include buildings essential to administration of Government departments; monuments, parks, grounds; parking areas; warehouses; hospitals; and other Federal facilities to serve governmental operations, Government employees, local residents, and visitors. The problem of Federal-District fiscal relations has been the subject of several special inquiries.[29] The view prevails that a payment formula related solely to the volume of exempt real-estate holdings is not appropriate. The fiscal problem will probably have to continue to be handled by Congress through the system of special grants and appropriations.

(2) *Properties used in general administration outside the District of Columbia.*—These facilities include office buildings, headquarters, and storage properties used in general Federal administration; the post offices and postal-service properties; research laboratories, and other experimental facilities; observatories and weather stations; courthouses, customs houses and mints, depositories, and assay offices. The holdings are of long standing, no payments to local governments have been made, and only the Postal Service is significantly productive of revenue in the enterprise sense. Tax losses are small, usually involving sites alone. Heavy concentrations do not occur in any given community outside Washington, D. C., and the local public services required are not important. In view of these factors and the commercial benefits normally accruing to the communities, local complaint has been insignificant. These considerations and the tra-

[28] The classification was suggested by that being used by the Federal Real Estate Board and the reports of the National Resources Planning Board, Public Land Acquisition, pt. I, Rural Lands, June 1940; Public Land Acquisition, pt. II, Rural Lands, February 1941.

[29] Cf. Fiscal Relations Between the United States and the District of Columbia, S. Doc. 12, 75th Cong., 1st sess.

ditional governmental nature of the property, to which adjustments have been made, suggest no valid case for initiating payments.

(3) *Facilities for furtherance of transportation and communication.*—The bulk of these properties are used to encourage and protect commerce, navigation, and communications. They include lighthouses, coast-guard stations, shops, warehouses, testing stations, beacons, and radio stations.

The Inland Waterways Corporation, operating barge and rail lines, is apparently subject to taxation on real property by congressional consent, although payments made are small and tax allowances are not specifically provided for in rates.[30] It would probably be generally agreed that railways operated on a commercial basis, now or in the future, should be subjected by law to real-property taxation, or that provision be made for full payment of equivalent sums in lieu of taxes. The purely protective and stimulative exercise of the commerce function does not appear to warrant payment. The considerations involved are the same as those urged in the case of the general administrative functions. With respect to nonmilitary airfields, the bulk of the Federal program has been based upon municipal land ownership, and has come as a result of local solicitation of national assistance. Any federally owned airports leased to localities would presumably call for local maintenance and local retention of revenues. In the event that any airports were permanently operated by the Federal Government on a commercial basis, a local share of revenue might be justified.

(4) *Facilities for institutional care, correction, and welfare of special Federal charges.*—The facilities covered by this classification include public health laboratories; quarantine stations; hospitals and health farms; prisons; immigration stations; cemeteries. Considerations are similar to those mentioned for administrative properties. Institutions of this type are typically exempted from State and local taxation, whether operated by public or private nonprofit organizations. Some of the properties may be construed as of doubtful benefit to the local areas within which they are situated, but the property tax loss is normally not significant. No payments are now made, and no case for payments is apparent.

(5) *Surplus real estate.*—This category includes a wide variety of scattered sites and old public buildings and structures awaiting disposition. Concentrations in given localities are not serious, and most of the statements made as to general administrative property are applicable. If holdings are not turned over to general administrative agencies for use, they remain idle, are leased to private parties, or are sold. Rental income is low in view of uncertain tenure under 30-day notice of termination and of the fact that much of the property is not suitable for private use. No payments are suggested, although it would be desirable that title pass at an early date in the case of sale to private owners in order that the property again be placed on the tax rolls.

(6) *National defense.*—This category includes camps, powder reservations, training areas, airfields, forts, ranges, docks, yards, schools, arsenals, plants and similar facilities administered by the Army and Navy; and war plants, yards, and warehouses owned by the Defense Plants Corporation of the Reconstruction Finance Corporation.

[30] U. S. C. title 49, sec. 153 F.

Under the original act and subsequent amendments, all real property of the Reconstruction Finance Corporation and its subsidiary corporations, including the Defense Plants Corporation, is made subject to State and local taxation.[31] Most of the Reconstruction Finance Corporation-owned war plants are operated by private companies as a part of their own facilities under lease agreement, and a number will be sold to private owners after the war. The major complaint with respect to Reconstruction Finance Corporation plants appears to be the lack of consent to tax machinery and other tangible personalty to which the Reconstruction Finance Corporation holds title. In view of the extensive substitution of governmental capital for private financing, a reasonable case for such taxation can be made.

In addition to permanent Federal arsenals and naval yards, the Army and Navy and Maritime Commission own a considerable number of new industrial plants, many of which are operated by private business. In some instances, the plants are located on the property of the private operator among his other facilities. No taxes or payments in lieu of taxes are made. Any such payments are likely to be opposed as adding to the cost of the war program, and the arguments presented that the permanent arsenals have always been exempt and that the new facilities are for temporary emergency use. Logically, all Government-owned and privately operated production facilities should be treated on the same basis and payments in lieu of taxes made at least on the real estate. The permanent yards and arsenals operated by Government personnel could be exempted from such payments, or payments made to the extent suggested below for other Army and Navy establishments.

Other Army and Navy properties, such as camps, airfields, and bases, likewise make no payments to local governments on exempt holdings as such. Since the function is entirely governmental, and many of the holdings are of long standing, it might appear that the principle of nonpayment applied to general administrative properties should be operative. In the current period, however, heavy acquisitions of valuable taxable property have been made which pose serious problems for the local governments affected. In rural areas in particular, many holdings are of an extensive character. Much post-war disposal may occur, however. The situation is further complicated by the fact that exclusive Federal jurisdiction is obtained over most of the areas and there is no obligation on the part of the local units to provide public services. As a matter of fact, many public services are not required, or are performed with Federal funds by the armed services themselves. Those local services required are cared for by special contracts with localities, combinations of direct Federal construction and contract, tuition payments by personnel, voluntary State and local provision without cost, etc.[32] Many serious local situations have been eased by Federal Defense Public Works grants and loans for public facilities and grants for operation and maintenance of such facilities.[33] This type of aid has been extended to congested and financially strained war areas in general and is not necessarily confined to areas affected by tax-exempt holdings alone.

[31] 47 Stat. 9 c. 8, par. 10, as amended by Public Law 108, 77th Cong., sec. 3.
[32] L. E. Blauch and W. L. Iversen, Education of Children on Federal Reservations, Staff Study No. 17, Advisory Committee on Education, 1939.
[33] P. L. 137, 77th Cong., approved June 28, 1940; P. L. 409, approved January 21, 1942.

One reasonable additional adjustment would be payment in lieu of local taxes on the original assessed value of land acquired since the beginning of the current emergency, such payments to be offset against any special charges for tax-supported public services rendered by the local jurisdiction. A more formal arrangement for paying school tuition of children of military personnel with Federal funds would be desirable. By such arrangements the local units adversely affected as to tax base and not receiving other payments would receive some compensation.

(7) *Properties used in preservation and development of surface and subsurface land resources and scenic and historic sites.*—This classification includes the unallocated public domain; mineral and grazing areas of the public lands; national parks; reclamation works; game refuges; and revested land grants, largely under the Department of the Interior. The Department of Agriculture also administers the national forests and submarginal land retirement and development projects. The great bulk of the holdings consist of the public lands, although acquired lands are occasionally an important element. Sometimes both public domain lands and acquired lands are intermingled and jointly administered. A few projects are leased for long terms to States or local units at nominal charges. In these cases, any compensation to local government would appear to be primarily an intrastate matter.

The conservation land holdings affect principally rural local governments, often low in taxable resources. Forest land and submarginal land acquisitions are commonly heaviest in weak economic areas, and fiscal and organizational shortcomings may antedate, or be independent of, the Federal real-estate holding. Lands acquired by purchase are generally of low value, often with delinquent taxes that are paid to the local unit upon Federal purchase. Settlement in the areas purchased may be reduced and, in time, some costs for public services eliminated, although this may be incompletely realized because of failure to acquire all occupied tracts in the area. An important State responsibility in helping to equalize benefits and burdens of public purchase appears to be involved. This includes attention to necessary reorganization of local units and services and distribution of Federal payments and State-aid funds to prevent maintenance of parasitic local entities.

(*a*) United States Department of Agriculture: On extensive holdings of purchased submarginal farm land, the Department pays 25 percent of net proceeds to counties for roads and schools. Receipts are negligible pending restoration of land resources.

The Treasury pays to States, on lands of the national forests, 25 percent of gross receipts to be distributed for the benefit of counties where the land is located. Funds may be used for roads and schools only. An additional 10 percent of moneys received from the forests is available for Forest Service expenditures on forest roads and trails in the States from which proceeds are derived.[34] Local units have complained of the lack of receipts from acquired land pending restoration; the instability of receipts; the practice of apportionment according to area rather than value; and restriction of proceeds to road and school use.

[34] U. S. C., title 16, secs. 500, 501.

The Department, after careful field study, has been considering a revised uniform plan to apply to both submarginal and forest lands.[35] It is suggested that 25 percent of gross receipts be distributed to States for the benefit of counties, without restriction as to purpose of expenditure. Timber receipts would be distributed according to value of standing timber in each county, and the receipts for any State from this source would not be permitted to exceed one-half of 1 percent of the value of standing timber in the State. Other receipts would be distributed to counties according to the contribution of the land in each county to gross receipts. A five-year average might be employed to assure stability of the distributions. Until exceeded by 25 percent of gross revenue from all lands, a minimum guaranty of a flat rate of between 0.5 and 1 percent on value of acquired lands (value of acquisition with later adjustments for net decreases in value of timber) would also be paid. This interim payment is designed to compensate those areas where taxable land has been purchased and which will not yield revenue until timber is restored. The minimum flat rate would not be applied to public domain lands, but only to lands acquired by purchase, donation, and exchange.

The plan combines administrative feasibility with reasonably good practice relative to tax payment on depleted lands. Only a few States have adopted policies of preferential tax treatment of cut-over lands to promote restoration of timber. Taxation by usual local methods is productive of land abandonment and tax reversion to the States and counties. The above plan combines a low but reasonably liberal interim payment with what is in effect a severance tax when timber is harvested. Removal of restrictions as to use of funds for schools and roads only is desirable in view of the fact that debt retirement and general local administration may be the main functions requiring special financial assistance. State aids for schools and roads, particularly on an equalization basis, reduction of school and road costs by removal of settlement, and Federal road construction and maintenance, may all affect the local need for funds for the school and road functions.

The Department of Agriculture plan is believed to be carefully devised and worthy of application to the categories indicated. The flat rate of 0.5 percent on value at time of acquisition would slightly exceed average rural property-tax rates on full value in one or two States. A rate of 1 percent, still below the national average of 1.18 percent of full value, would not exceed average rural rates in a significant number of States.[36] Detailed adjustment to the variable rates of thousands of local taxing districts would not be feasible administratively, nor would it conform to desirable practice. The choice of rates is a matter of the weight given many tangible and intangible factors. The 1-percent rate would not involve a great increase in present total distributions in the case of national forest lands and would be most satisfactory to local units. The plan has the further advantage of a general resemblance to property taxation according to value and of rendering the local receipts more stable and predictable for budgetary purposes.

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[35] The plan is outlined in Hugo C. Schwartz, "Governmental Tax Immunity," Land Policy Review, May-June 1941, pp. 37-41.

[36] Farm Real Estate Taxes in 1940, U. S. Department of Agriculture, Bureau of Agricultural Economics, February 16, 1942, table 3 (mimeographed). A rate below average rural property tax rates on full value is further justified in view of the usual record of tax delinquency on the type of land purchased and Federal construction and maintenance of roads and trails.

While the Department plan does not definitely earmark payments to the States for particular local jurisdictions, the allocation of computed payments is by counties. It should be clearly indicated that the States may distribute the funds in any manner desired in the event that reorganization of residual local units is contemplated.

(*b*) United States Department of the Interior: The Bureau of Reclamation administers some of the public lands in 15 Western States and may acquire sites for reclamation works. Except for commercial power development, no payments to local government are made, and no payments appear justified on either the public lands or the taxable private lands acquired for works. The Western States benefit heavily from expenditure of the reclamation fund created out of proceeds of public-land sales, royalties, and repayment of construction costs. Taxable wealth is directly increased by the reclamation function, and the land and works of such special land improvement enterprises as irrigation and drainage districts are customarily exempted by State and local law. Should private taxable lands be purchased by the Federal Government merely for purposes of controlling land speculation and settlement, submission to local taxation or payments equivalent to taxes would be justified.

A considerable area of public land is administered in grazing districts under the Taylor Grazing Act.[37] Fifty percent of proceeds from leasing to livestock operators is returned to the States for the benefit of counties, although much of this money finds its way back into range improvement by State donation to the Grazing Service. Twenty-five percent of grazing-district proceeds from ceded Indian lands is distributed to the States for schools and roads of the counties involved.[38] Fifty percent of grazing receipts from public lands outside grazing districts is also returned to States for the benefit of counties.

The General Land Office distributes to States 5 percent of net proceeds from sale of public lands to certain States for roads and schools;[39] 37½ percent of royalties from public mineral and potash lands to States for schools and roads;[40] 37½ percent of oil and gas royalties from certain Indian lands to Oklahoma for roads and schools.[41] On particular revested railroad and wagon road grant lands in Oregon, 50 to 75 percent of receipts are to be paid to the counties in lieu of taxes.[42] The latter lands were formerly taxable as distinguished from the rest of the public domain.

The Fish and Wildlife Service administers both public domain and acquired lands for bird and game refuges. Twenty-five percent of net revenues is distributed to counties for roads and schools.[43] Receipts are small, local services required negligible, and land values low. It is suggested that the method of payment be adjusted along the lines proposed for national forest lands.

The Park Service also administers both public domain and acquired land. No payments are made, although some revenue is derived. It is suggested that payments be made in the manner proposed for national forest lands.

Most of the public-domain States have claimed that continued large Federal holdings deprive them of sovereignty and anticipated tax

[37] 48 Stat. 1269, June 28, 1934; U. S. C., Supp. V, title 43, sec. 315 I, 315 M-4.
[38] U. S. C., title 43, sec. 315 J, sec. 315 M-4.
[39] U. S. C., title 31, sec. 711 (17).
[40] U. S. C., title 30, sec. 191.
[41] 44 Stat. 740; U. S. C. title 30, sec. 191.
[42] 44 Stat. 915; 50 Stat. 875; 40 Stat. 1179; 50 Stat. 874; 50 Stat. 753.
[43] U. S. C., Supp. V, title 16, sec. 715 A.

revenue. Particular objection has been raised to the recent withdrawal from entry of most of the remaining public lands. Since the bulk of this land was never taxable, and local governments were organized with reference to that fact, it is not suggested that any new departure be made in payments on account of these holdings as such. Most of the unallocated public domain is of low value, does not involve serious public costs, and where productive of revenue, such revenues are shared. While the percentages of revenue-sharing are not uniform and apparently quite arbitrarily determined, the arrangements are of long standing and need not be disturbed. Actually, Federal grants of money and land, reclamation, and other development-fund expenditures, have been designed to cast extra benefits upon public-land States, usually in contemplation of the extent of Federal holdings. Conservation of land and regulated private use have the effect of stabilizing the economy and increasing taxable values in the area, including those of cattle and other personalty. The major problems in the public-land States appear to concern the manner of allocation of private rights to use the public domain for grazing and the withdrawal of other land from taxable ownership. The latter problem is believed to be adequately treated under the plans suggested.

(*c*) United States Army flood control and river and harbor improvements: Flood-control dams and reservoirs frequently result in removal of large areas of valuable lands from local tax bases. In the case of the Mississippi Valley projects 25 percent of gross receipts from leasing of lands so purchased is paid the States to be used for local schools and roads.[44] This provision might be made generally applicable, although revenues are not large from lands that may be permanently or intermittently flooded. The benefits from flood protection to taxable property are direct and considerable, although the large land acquisitions are not always located in the areas directly benefited. It might be feasible to authorize the application of the minimum low flat-rate guaranty on original land value suggested for forest lands in those cases where no protective benefit is derived or tax loss manifestly exceeds such benefit.

The case for payments in connection with other river and harbor improvements is not as clear. Not as much adverse effect on the tax base is involved, and localized benefit of a tangible character is even more apparent. Improvements of both types are actively solicited by and on behalf of the localities. As a matter of fact, if Federal funds were not supplied, flood-protection works would often have to be financed from local general tax or special assessment funds.

(8) *Conservation and development of water and power resources.*—Reclamation and flood control have already been discussed, hence the above category involves principally the development of public power. Some projects, however, involve many purposes of regional and national development in addition to power production, including navigation, war production, flood control, recreation, watershed protection, reclamation, wildlife, and forestry development. The Tennessee Valley Authority program involves many of these features. The Authority has provided a number of usual public services to its employees and has given direct assistance to local governments in

[44] U. S. C., Supp. V, title 33, sec. 702A-11.

performance of general public services in the area.[45] The Bureau of Reclamation, however, is the largest factor in Federal agency power production. Demands for payments in lieu of taxes have been made for nearly all the public power developments, but only the Tennessee Valley Authority and Boulder Dam developments are making such payments. The Federal Power Commission distributes to States 37½ percent of receipts from licenses for use of public lands as power sites, but this minor payment follows the usual plan of revenue sharing on the public lands.[46]

After long controversy, the Tennessee Valley Authority has revised its plan of payment to distribute a percentage of annual gross proceeds from commercial power sales. The percentage diminishes from 10 in 1940 to 5 in 1948 and subsequent years. The apportionment among States is made, one-half according to the percentage of power sale proceeds in the State to total proceeds, and one-half according to the percentage of book value of power property located in the State to total book value. No State in which power property is held shall receive less than $10,000 or less than the 2-year average of State and local ad valorem taxes last levied against original private properties acquired and allocated to power. The counties receive their share of the property-tax-replacement guaranty by direct distribution.[47] This latter provision may have some disadvantage in creating an undue vested interest in the payments by small counties requiring reorganization.

The plan, coupled with payments to be made by municipally owned and cooperative systems buying power from the Tennessee Valley Authority, will replace all actual property-tax losses from the acquisition of power properties. Additional receipts will very nearly replace the business taxes formerly levied on private utilities acquired. The plan does not cover tax-equivalent payments on the new Federal construction or on lands not allocated to power. Tennessee Valley Authority power rates include a loading which is said to approximate taxes that would be levied on the power development if it were entirely privately owned. The declining percentage of revenues to be distributed from 1940 to 1948 is said to be calculated to permit gradual local fiscal adjustment, and to keep the distribution more or less at current levels as revenues increase. As such, the percentages have no direct relation to full tax-equivalent payments on the entire development.

The Boulder Dam project now makes payments of $300,000 a year each to Arizona and Nevada. The flat payments were in commutation of a previous revenue-sharing arrangement of uncertain yield.[48] Actual tax losses on original acquired property in the States were negligible, and the payment was made in consideration of State "rights" to the water resources and of the fact that the site might have been developed privately and been productive of tax revenue.

In the interest of making full payments in lieu of taxes on the entire commercial power element of public projects, it is suggested that the value of power property be derived by a process of capitalizing commercial-power income. After adjustment of such "full value" to local valuation practice, regular ad valorem rates would be applied

[45] Lawrence L. Durisch, "Local Government and the Tennessee Valley Authority Program," Public Administration Review, 1:4, summer 1941, pp. 326-334.
[46] U. S. C., Supp. V, title 16, sec. 810.
[47] Public Res. 88, ch. 432, 76th Cong., 3d sess.
[48] Public Law 756, 76th Cong., 3d sess., July 19, 1940, ch. 643.

and payment made to the State. This might be coupled with a minimum guaranty of replacement of ad valorem taxes on original properties acquired from private ownership and allocated to power. On nonpower phases of the development, payments would be expected to follow the practice in other Federal properties of a similar character. Power rates would be expected to contain a loading fully equivalent to the tax charges that would be paid under private ownership. The suggested capitalization process is admittedly not developed as a technique for detailed application, however, and it is realized that multipurpose reclamation power projects involve complex special conditions of local area benefits which require further study.

(9) *Holdings for assistance to low-income groups, disadvantaged classes, and for emergency housing.*—This classification involves rural resettlement farm lands and projects; migratory-labor camps, houses, and shelters; urban low-cost housing and slum-clearance projects; and Indian lands. There is a strong case for full payment in lieu of ad valorem taxes on rural resettlement properties and defense housing described below. Low-rent housing and slum-clearance projects, because of their social objectives, should make payments in lieu of taxes based on ability to pay as reflected in rentals charged. The only exception to making payments in lieu of taxes would appear to be those Indian lands that have never been taxed and that involve special legal and other problems to be described.

(*a*) Rural resettlement properties: The Farm Security Administration is authorized by the Bankhead-Black Act to make payments in lieu of taxes to States and local units, taking into consideration costs of public services rendered and benefits conferred by the projects.[49] On those properties to which the United States retains title, the Farm Security Administration pays the equivalent of property taxes by annual agreement. Such payment, except in a few cases, was considered to be the only feasible means of allowing for the factors of cost and benefit. Studies are made of local assessment ratios and assessment practices, and properties are valued according to local methods. Full ad valorem rates are applied to valuations so derived. The practice has been generally successful, except for somewhat cumbersome administrative procedure resulting from legal interpretation of the act. Many small payments are made and an unduly large number of agreements with individual taxing districts must be renewed each year. This results from interpretation of the agreements as contracts for services with each minor taxing and service-rendering jurisdiction and from failure to establish a regular procedure for local certification of rates.

As in the rest of this category, full tax-equivalent payments are justifiable in view of the private use of the property and the inequity of imposing the added public costs on other local property owners as a further subsidy to the aided Federal clients. The Federal clients may be in competition with neighboring owner-operators and tenants, many of whom are in no better circumstances, yet pay property taxes. Strong local opposition to tax exemption early in the resettlement program hastened the passage of the enabling legislation.

(*b*) Urban low-cost housing: The United States Housing Authority retains title to a group of low-cost urban housing and slum-clearance

[49] 49 Stat. 2036, 1936.

projects constructed prior to the development of a program of financial assistance to locally conducted public housing. A number of these projects are leased to local housing authorities. The 1937 Housing Act authorizes agreements to pay sums in lieu of taxes to States and localities on any real property owned by the Federal authority, but not in excess of taxes which would otherwise be levied.[50] Actually, payments made are far less than tax equivalents and are generally limited to not more than 5 percent of shelter rent. Payments are not made to all taxing jurisdictions, and contracts for municipal services without any charge are sought. The same practice is followed with respect to those federally owned projects leased to localities. Such payments as are made are arranged by the local housing authorities and deducted from lease payments to the Federal agency.

The bulk of the peacetime public-housing program involves local ownership of the property with Federal financial assistance. Tax exemption is normally accorded by State statute, and the Federal law requires local tax remissions, tax exemptions, or cash contributions up to 20 percent of the annual Federal contribution or the capital grants in lieu of subsidies. Payments in lieu of taxes to local governments by the local housing authorities have recently been increased pursuant to a liberalized policy adopted by the Federal Public Housing Authority (successor to the U. S. Housing Authority). Income of the projects over and above expenses and debt service is shared in the ratio established by law, one-sixth of the net income being available for payments in lieu of taxes and five-sixths going to the reduction of Federal subsidy. In no event are payments in lieu of taxes less than 5 percent of shelter rent.

The entire program has been based upon substantial tax exemption as an expedient means of local financial participation and achievement of low rentals. The localities have the option of refusing the projects if they do not wish them—a circumstance which might not be true of direct Federal programs. The case for exemption is built up on grounds of low actual-tax revenue loss, increases in value of surrounding property, and reduction in the public costs of serving property and persons in slum areas. It will require considerable reexamination in view of contemplated enlargment of public-works housing in post-war years. The need for revenue in older municipalities, serious reduction in the tax base, and the inequitable shifting to other property taxpayers, will be particularly acute under enlarged programs.

It is suggested that in any low-rent housing program in the post-war period the amounts to be paid in lieu of taxes should recognize the social objectives of the program, the local government's own responsibility in remedying slum conditions, and the necessity for local and Federal aid in achieving rents low enough to rehouse low-income families from the slums. Payments in lieu of taxes should be made on a contractual basis taking into account the ability to pay of the families rehoused as reflected by the rentals charged in the project. Payments should also of course be adjusted for any specific facilities constructed or services supplied by the project which would otherwise have been provided at general local public expense. On existing

[50] 50 Stat. 888, 1937; 42 U. S. C. 1401, Supp. 1939.

housing projects arrangements for payments in lieu of taxes already embodied in contracts and relied upon by bondholders should not be upset.

(*c*) Defense housing: As distinguished from the regular public-housing programs, the bulk of federally owned defense housing under the Lanham Act involves rentals approximating those of the market. This act, as recently amended, makes it mandatory to pay the full equivalent of local property taxes, less any benefits from Federal provision of facilities which would otherwise have been provided at general local public expense.[51] There is not yet much experience with this provision, but it appears superior to the previous plan of permissive payments. The permissive-payment plan involved tax-equivalent payment as a maximum, and payments on original site valuation as a minimum.[52] Except in extraordinary cases, payments did not exceed 15 percent of income from shelter rent, distributed among selected municipal functions according to census data on average distribution of municipal expenditures. Payments were not made to all taxing units or for all local functions, and were generally less than taxes.

The United States Housing Authority and local authorities have also engaged in defense housing. The former is able to make full payments in lieu of taxes under its authorization, if it desires, and the latter are being authorized by State laws to make some additional payments to municipalities for local services. Practice has now been made uniform in respect to the great bulk of all war housing which was brought under the Federal Public Housing Authority by the recent consolidation order, and the policy is now to pay the full equivalent of local property taxes. Certain Army and Navy housing projects, often on reservation property, have no specific authorization to make payments in lieu of taxes. Unfortunately, exclusive jurisdiction is frequently involved, and the public-service problem must be handled by special contractual arrangements or direct Federal provision of some of the services, as described previously with respect to Army and Navy properties.

In brief, practice with respect to housing has been extremely variable and there has been a tendency to make only partial payments for specific services. In some cases, because of unwillingness, financial inability, or for other reasons, some of the usual public facilities and services have been directly provided by the Federal project.

It is suggested that full tax-equivalent payments in lieu of taxes be made to localities on all Federal projects, with adjustments for any services or facilities directly provided for housing projects at Federal expense, which would otherwise have been financed out of local general tax funds. The recent consolidation of the multitude of defense housing agencies has now brought uniformity of policy in this respect. In view of the low rental character of some of the projects, capitalization of income may be a necessary factor in the process of valuing such property. Although many war housing projects are to be disposed of as rapidly as possible under the law, public facilities constructed by the Federal Government (which relieve the drain on local tax funds) could possibly be recognized in the distribution of payments in lieu of taxes.[53] Wherever possible, it would appear desirable to utilize

[51] Public Law 409, 77th Cong., sec. 8.

[52] Public Law 137, 77th Cong., approved June 28, 1941, sec. 4 (b).

[53] Because of the local need for funds in congested war production and military areas, and the uncertainty regarding the future use of the facilities, it may in practice be necessary to ignore this factor.

locally provided facilities and services fully, rather than to provide separate facilities or arrange for services on the basis of special contract.

(*d*) Indian lands: The Indian lands also come within the category of assistance to special groups. Most of the properties have been held for many years under trusteeship and do not represent Federal holdings in the usual sense. Unrestricted individual Indian lands are fully taxable, but the balance have been long exempt under the Federal Constitution, various State constitutions, compacts, and laws. The United States has performed many of the usual local public functions for nontaxable Indians, including provision of certain school, health and hospital, welfare, relief, and law-enforcement services. Nevertheless, local public services, including schools and roads, are used to a considerable degree. In addition to this mixture of public-service factors, the land ownership and use patterns, and the commingling of taxable white and Indian lands with nontaxable Indian lands are complex. This situation is further confused by the leasing of many nontaxable Indian lands to white settlers. As in the case of the public domain, there has been an adjustment by local government to tax exemption of those lands long held, and much land has been added to the tax rolls over the years by alienation and the removal of restrictions on individual Indians. The Office of Indian Affairs pays tuition at low rates to States and local districts, amounting to about $1,000,000 a year for nontaxable Indians attending public schools.[54]

The process of alienation has now been halted, and a program of purchase of lands has been inaugurated to increase the diminished basis for Indian economic support.[55] An equitable adjustment of the situation might include full Federal payment in lieu of local taxes on the lands acquired from taxable ownership, and more adequate school-tuition payments than are now made for nontaxable Indians. It would be difficult to arrive at a formula which would take into consideration the confused situation of ownership status, location of property and persons, use of public services, segregation of tribal funds, and long-standing legal tax exemption. No payments are recommended to apply to Federal administration buildings, hospitals, schools, and their sites.

(10) *Properties held by Federal lending agencies.*—With very minor exceptions, real estate held by Federal credit and lending agencies is subject to State and local taxation. This has been provided for by specific congressional consent. The property covered is chiefly acquired by foreclosure and is not usually intended for retention. The legislation applies to: The various farm-credit organizations in, or associated with, the Department of Agriculture, and which make secured loans; the land banks; the deposit-insurance and mortgage-insurance agencies; Federal credit unions; Federal Reserve banks, etc. The Reconstruction Finance Corporation and Inland Waterways Corporation provisions have already been discussed. This practice deserves to be generally applied to holdings of this type, in view of their essentially private character, the temporary period of holding, the business aspects of most of the Federal enterprises, and the fact that revenue may be derived from the property during the holding period.

[54] Lloyd E. Blauch, Educational Service for Indians, Staff Study No. 18, Advisory Committee on Education, Washington, 1939, pp. 95-100.

[55] National Resources Planning Board, Public Land Acquisition, pt. I, Washington, June 1940, pp. 20-21.

(*h*) *Conclusion.*

The suggestions made by no means dispose of all outstanding problems and conflicts. The tax-exemption problems associated with administration and use of the public domain lands in the Western States will remain a subject of contention. The field is one for continuing examination and adjustment. The amount of consideration which must be given the tax-exemption question by congressional committees and Federal administrative agencies, both with respect to specific complaints and broad policy, renders the subject an appropriate one for the deliberations of any Federal-State Fiscal Authority which may be established.

This report has tended to favor distribution of funds to States, rather than directly to local units, in the belief that State responsibility should be developed in redistribution according to need, or with reference to local reorganization and the operation of State-aid systems in appropriate situations. This is particularly pertinent in instances of extensive Federal acquisitions and large payments and need not be applicable in the case of scattered properties, or holdings such as housing projects in municipalities. A greater degree of Federal-State cooperation in the planning of land acquisitions and the adjustment of local areas and services is needed. This would include such seemingly minor matters as procedure for prompt local recording of exempt status and adjustment of Federal payments in lieu of taxes to other local fiscal procedures. Extensive post-war public-works programs now being planned will unquestionably involve large additional public purchase and development of both urban and rural lands and will render the exemption problem even more important quantitatively than it is now.

2. STATE AND LOCAL TAXATION OF GOVERNMENT CONTRACTS

(*a*) *Nature and development of the problem.*

Property tax and equivalent payments are in most instances restricted to real-estate taxes. But the applicability of other taxes to Federal instrumentalities or quasi-instrumentalities also gives difficulty and has been particularly troublesome during the war period.

The taxability of Government contracts under State and local sales and use taxes is one of the war-created problems in intergovernmental fiscal relations.[60] Pending the Supreme Court's determination of the taxability of war contracts, the Justice Department endeavored to obtain suspension of State tax collections. A number of States complied. Objection was raised to such State taxation on the ground that the latter would add to the cost of the war program, and that the legal status of operations of many war contractors as private individuals or agents of the Government was unclear. Of particular significance was the status of cost-plus-fixed-fee contractors. This type of

[60] In October 1940 the Buck Act (Public, No. 819, 76th Cong.) was passed to authorize States to extend sales, use, and income taxes to persons residing on or carrying on business in Federal areas and to transactions occurring in such areas. The provisions did not apply to "authorized purchasers" (military, naval, and civilian employees) from Federal instrumentalities. Some attempt has been made to amend the act to further clarify Army and Navy authority over reservations and to extend to Army and Navy personnel exemption from State income taxes, but no legislation has been passed to date. In general, State sales taxes do not apply to purchases made by Army personnel at Army exchanges, but the question cannot be considered closed. The exchanges do a very large business and the Army Motion Picture Service operates the largest chain of motion-picture theaters in point of numbers in the country. (See Ernest M. Brannon, "State Taxation of National Defense Activities," Taxes, 20: 5, May 1942, pp. 268-271.)

contract is used extensively by the War Department, Navy Department, Public Buildings Administration, and the Maritime Commission. It is used also by the Reconstruction Finance Corporation.

Several States ruled that the cost-plus contractors working on war contracts are subject to sales, use, gross receipts, and similar taxes in the same manner as private contractors.

The Department of Justice took the position that the cost-plus contractor is an agent of the United States and the assessment of State sales and use taxes on the materials would be direct taxation of the Federal Government,[57] because:

1. The cost-plus contractor is reimbursed by the Government for all expenses and costs of equipment, materials, and labor and then receives a fixed fee for the use of his organization, services, and overhead;
2. The Government supervises all procurement, may itself supply the materials, and may specify the kinds of materials; and the Quartermaster approves virtually all purchases and receives delivery, and many of the invoices are on Federal forms; and
3. Title vests in the United States at the site of the work.

The Justice Department did not contest State and local taxation when the tax is actually on the seller but did so when the "legal incidence" is on the buyer. Taxes on sales within a State are usually collected from the seller but occasionally are levied on the purchaser, and more often there is a requirement that the tax be passed on to purchasers. In such cases, the Department argued, the buyer carries the legal incidence of the tax. Use taxes and gross-receipts taxes measured by payments received by the contractor from the Government for his expenditures on materials and labor, were held to involve the same principle as sales taxes. State net income taxes and gross-receipts taxes on the contractor's fee were not challenged.

At the time the issue was first brought sharply to public attention, a large number of the 91 separate sales taxes (including motor-fuel taxes) offered express exemption to the United States, and some States had extended exemption by administrative ruling. At the time the Government prepared its brief in the Alabama cases (below) the situation was described as follows:

> In 7 States the administrative construction has exempted the cost-plus-a-fixed-fee contractor from excise taxes; in 6 States a qualified exemption has been granted; in 16 States exemption has been denied; and in 8 States there has been no clear administrative construction.[58]

The confusion concerning cost-plus contractors was due to lack of legal precedent, and to the fact that Congress took no specific action, other than to refuse to include express immunity in the appropriation act. Two test cases have recently come before the United States Supreme Court: *U. S. and Dunn Construction Co.* v. *Curry;* and *Alabama* v. *King and Boozer.*[59] The first case tested an Alabama use tax on property purchased for construction of a camp. The second involved an Alabama sales tax on lumber for the same camp. The Supreme Court of Alabama had upheld the Federal Government in

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[57] S. O. Clark, "State Tax Affairs and the Defense Program," paper before Municipal Law Section of American Bar Association, September 30, 1941 (mimeographed)

[58] Brief for the United States in *State of Alabama* v. *King & Boozer*, 1941, pp. 108-109.

[59] 62 Sup. Ct. 48 (1941); 62 Sup. Ct. 47 (1941).

these cases. The United States Court held that Alabama taxes were applicable.

Justice Stone, for the Court in the Boozer case, stated that the contractors—

were not relieved of the liability to pay the tax either because the contractors in a loose and general sense were acting for the Government in purchasing the lumber or, as the Alabama Supreme Court seems to have thought, because the economic burden of the tax imposed upon the purchaser would be shifted to the Government by reason of the contract to reimburse the contractors.

Concerning this latter point the Chief Justice added:

The Government, rightly we think, disclaims any contention that the Constitution, unaided by congressional legislation, prohibits a tax exacted from the contractors merely because it is passed on economically, by terms of the contract or otherwise, as a part of the construction cost to the Government. So far as such a nondiscriminatory State tax upon the contractors enters into the cost of the materials to the Government, that is but a normal incident of the organization within the same territory of the two independent taxing sovereignties.

Subsequent to the Supreme Court decision in the Alabama case, bills were introduced in Congress to relieve contractors from the burden of State excise taxes on Government contracts.[60] Real estate and personal property taxes, and social-security taxes were to be left unaffected. A retroactive provision proposed to outlaw uncollected claims arising during the emergency and before the bills might become law.

Supporters of these bills argued that State taxation of Government contracts added a heavy administrative burden to the task of war procurement and introduced uncertainties and other complications for war contractors, including pressure to divulge military secrets; that such taxation was adding greatly to the cost of the war (perhaps eventually over one billion dollars might be so added, it was alleged); and that the existing arrangement operated unfairly among the States, since those that had a sales tax, and were already benefited by Federal dispensation of large contracts, were profiteering at the expense of the Federal Government.[61] Opponents answered that administrative problems and uncertainties would be increased rather than diminished were contractors made immune from State sales taxes; that discrimination would result from the application of the retroactive feature of the proposal in favor of contractors who had delayed payment of taxes as contrasted with those who had paid; that the distinction between sales and other taxes proposed in the bills was unwarranted; that the saving involved to the Federal Government had been exaggerated by the proponents; and that the States could ill afford to lose the revenue the bills would cost them. Doubt was expressed concerning the constitutionality of an attempt to immunize contractors without making them agents of the Federal Government.[62]

(*b*) *Estimates of additional Federal cost involved in allowing the States to tax war contracts.*

The brief presented by the Government in the Alabama case included an estimate of additional costs that would result from the taxability of sales.[63] This involved some elaborate analysis and cal-

[60] 77th Cong., 1st sess., H. R. 6049, and 2d sess., H. R. 6617 by Mr. Cochran, and 2d sess., H. R. 6750 by Mr. Doughton.

[61] House Committee on Ways and Means, Exemption of War Contracts from Certain State and other Local Taxes, 77th Cong., 2d sess., Rept. No. 2044; House Committee on Ways and Means, Hearings, Exempting Government Contractors from State and Local Taxes, March 4, 1942.

[62] Ibid.

[63] Brief for the United States, *Alabama* v. *King and Boozer*, appendix B.

culations performed with the assistance of the Bureau of Labor Statistics. The calculations assumed that States now exempting war contracts would discontinue the practice. In this respect the figures must be taken to represent a maximum, though it is stated that otherwise the calculations were conservative estimates. Expenditures by lump-sum contractors, not at issue, were so far as possible excluded. In the case of construction contracts the Bureau of Labor Statistics estimated that the margin of error in its estimates was probably less than 10 percent.

The estimated sales, gross receipts, and license taxes in connection with the activities of cost-plus-fixed-fee contractors and cost-plus-fixed-fee subcontractors on 405 construction contracts in effect on June 15, 1941, including both actual expenditures and estimated expenditures necessary to complete the projects, were $15,000,000. Motor-fuel taxes on the same contractors similarly computed were $7,000,000.[64] On the basis of a sample study, sales and gross-receipts taxes on 143 cost-plus-fixed-fee supply and equipment contracts executed prior to September 15, 1941, were calculated at $17,000,000. This makes a total of $40,000,000. These figures include 548 contracts and an estimated cost of $6,721,000,000. The figures are cumulative and not confined to 1 fiscal year. Projecting the estimates into the future it was found that the total outlay, for fiscal 1942, might be about $54,000,000. A figure was also estimated to cover the possibility that the Government might be held not immune from taxes on any of its purchases. The figure ventured for fiscal 1942 to cover this eventuality was $137,000,000.

In hearings on legislation to immunize Government contractors from State sales taxes, estimates on savings and costs involved ranged from $213,000,000 to $2,000,000,000.

In the brief for the United States in the King and Boozer case (appendix B), the estimates as previously stated, covered Government contracts of two sorts: construction contracts and supply and equipment contracts. For construction contracts the ratio of estimated sales-tax costs (including gasoline-tax costs) to the value of the contracts was 0.0085; for supply and equipment contracts the ratio was 0.0021. On the best available information (Budget Bureau), construction contracts are now running not to exceed 20 percent of the total, and the proportion is decreasing. Using the above data, the sales tax costs on $100,000,000,000 of contracts would be $338,000,000. This might mean a total cost of $480,000,000 on $142,000,000,000 of contracts contemplated at the time of the recent hearings on the bills which proposed to immunize Government contractors from State sales taxes. At the current rate of expenditure on contracts, the annual cost would probably not run over $162,000,000 and it might run substantially less. The calculation is generous, in that the assumption is made that all States taxing sales have modified their sales-tax statutes to include in the tax base sales to Government contractors, except for materials involved in resale to the Government. However, if the States should modify their sales-tax statutes so that sales of materials to be resold to exempted consumers would be made taxable, the figures might be too low. This, however, seems quite

[64] This figure, however, as stated in the report, makes no allowance for special State exemption for gasoline used off the highways, which might cover about 80 percent of the purchases in 39 States. In some cases the lower general sales taxes would cover such purchases where the motor-fuel tax would not.

unlikely. The above figures appear reasonable in comparison with State sales-tax revenues, the 1941 total amounting to $671,000,000.

(c) *Questions of policy and principle involved.*

To attempt to draw lines as to what should and should not be taxed in the field of governmental instrumentalities, as a matter of principle and public policy, is exceedingly difficult. There is first of all the line to be drawn between the taxation of property and that of sales. Few, if any, have seriously contended that the property owned by the Federal Government should be subject to State taxation at the will of the States. Of course, this is not to say that no payments should be made on Federal property in lieu of taxes. No one has contended that Federal purchases should be taxed at the will of the States, either. Congress should retain power to accept or waive direct taxes on its instrumentalities as it sees fit. Of course, after the Boozer decision, there is some doubt whether Congress even has the power to immunize contractors on their purchases for Federal contracts. But at least it has the power to immunize so far as its direct purchases are concerned, and perhaps it has this power in the case of cost-plus and independent contractors. Assuming it has all the power it needs, what should be its policy?

A stronger case can be made for leaving the States free to impose transaction taxes on Government purchases than for following a similar course in the case of property. A transaction tax always involves three parties, one almost always private. The economic incidence of the tax, as between the vendor and vendee, is usually somewhat obscure. A property tax on Government property involves no third party. The sales tax is ordinarily nondiscriminatory in administration; this is often not true of the property tax.

If the Federal Government were to allow all of its purchases to be subject to nondiscriminatory State sales taxes, could it adopt a similar policy with regard to Federal excises on State and municipal purchases? Would such a program require the consent or be subject to the discretion of the States? This is a question which remains to be answered by the Court. On the basis of the present trend in the Court's decisions, it seems quite possible that the application of a nondiscriminatory excise even on direct State purchases, with or without the consent of the States, or even despite legislation to the contrary in the States, might be sustained.

On principle it seems that the Federal Government might well go a considerable distance toward waiving immunity of its purchases from State transaction taxes. In support of this position the following considerations are offered:

1. All transactions of purchase, particularly those through a contractor, represent economic activity carried on in some State and local environment. They all require the usual amount of State and local governmental services. Taxes under such circumstances are, to repeat the words of the Court, "but a normal incident of the organization within the same territory of two independent taxing sovereignties." In the war era this economic activity often represents a substitution for other economic activity which would otherwise be fully taxable. To be sure, State and local territories get compensatory benefits from the location of war industries within their borders. They get similar benefits

from the location of private industries within their borders. It may be "good business" for these areas to hold out tax inducements to new industries or to retain old ones. Some communities have thought so. But somebody has to bear the costs of government, including the overhead left out of account in such decisions. It seems better that full cost be distributed over all of the economic activity. Indirect subsidies are always confusing and usually bad policy.

2. It is true that the imposition of sales taxes on Government business will increase the cost of defense. But this is not in any sense a dead loss. The extra cost to the Federal Government appears again as extra receipts for State and local governments. The same public is involved in supplying the treasuries of both. The Federal Government has much more adequate fiscal powers than the State and local governments. In recognition of this fact it distributes millions of dollars of Federal aid annually. In fact, it is urged by many to collect all the taxes now jointly used by it and the States. Much of the present distribution involves difficult formulas to determine the portion which should go to each unit. No formulas are involved in the payment of nondiscriminatory State and local taxes. To be sure, the State and local governments are showing an improvement in tax collections during the war period. But many of them have also been subject to a long period of financial strain resulting in some cases in prolonged deficits and a heavy floating debt. If these governments can improve their credit standing during the war period, they will be in better condition to meet the stresses of the postwar era and to cooperate with any public-works program the Federal Government may then see fit to inaugurate.

3. The policy of waiving immunity for State and local taxes on Federal transactions would strengthen the Treasury's position concerning the elimination of the tax-exemption privilege in the application of the Federal income tax to the interest on State and local bonds. In defending its case for the elimination of tax-exempt securities, the Federal Government makes much of the argument that the income tax is a nondiscriminatory tax and its application to the interest on government bonds would be "but a normal incident of the organization within the same territory of two independent taxing sovereignties." The Federal Government may well apply these arguments against itself as well as in its favor.

These arguments do not finally answer the question as to just what policy Congress should follow and the Treasury should endorse concerning the taxability of Federal purchases. In the light of the above analysis, it is concluded that such policy should (and perhaps in any event must) concede the taxability of independent and cost-plus-fixed-fee contractors. Going further it might allow taxes on all defense purchases. It is perhaps too much to expect that it will go the whole way, and attempt to eliminate all immunity on all Government purchases. But even this would, in our opinion, be well within the bounds of sound public policy.

3. TAX-EXEMPT SECURITIES

(*a*) *Introduction.*

An immunity problem of a different sort from those previously discussed is that of exemption of the interest on government bonds from income taxes. This differs from the problems above considered in that the interest is received by third parties, only indirectly related to governments. Intergovernmental relations have been strained for many years over the tax-exempt security issue. It is the proposal to include the interest on State and local bonds in the base of the Federal income tax which is most in conflict.

(*b*) *Historical background.*

The tax-exempt security issue is by no means a new element in American tax conflict. The attempt by the Federal Government to tax the interest on State and local bonds was one of the issues at stake in the Pollack decision,[65] which overruled the early income-tax statute of 1894. Passage of the sixteenth amendment, authorizing Federal taxation of income without apportionment according to population, involved a discussion of the question, and some assurances from the proponents of the amendment that it did not contemplate Federal power to tax the income from State and local securities.[66] As the graduation of rates increased, the exemption feature drew more and more criticism. Presidents Harding, Coolidge, and Roosevelt, and all the Secretaries of the Treasury since 1919, have opposed tax exemption and advocated its elimination at least as to future issues.[67] The power of the Federal Government to tax its own securities is conceded, but, as a matter of policy, many fully or partially tax-exempt Federal bonds have been issued, and the policy was not definitely discontinued as to new issues until 1941. In the case of outstanding Federal issues, the Government is bound by contract, and only by the gradual process of refunding and reissue can these obligations be made fully taxable. Fortunately, the volume of such fully tax-exempt securities is not very large. The immunity of State and local bonds from Federal taxation is protected by a long line of legal precedent. Recently the legal doctrine protecting State and local instrumentalities was revised by the Supreme Court to permit the taxation of the salaries of public officials.[68] This raised the hope of the proponents of exemption elimination that an effort to tax the interest on State and local bonds would also be sustained. The taxation by States of Federal bonds (through State income taxes and intangible property taxes) is also at stake, and would probably follow the same rule as that accepted for Federal taxation. During the 'twenties and middle 'thirties, attempts were made to secure congressional authorization of constitutional amendments to clear away legal impediments to the elimination of exemptions. These attempts were unsuccessful, and recent interest has centered about efforts to get action by Congress that would present the issue squarely to the Supreme Court. Early proposals covered future issues only, but in 1942 the Treasury advocated the taxation of all interest on all Government bonds, except in the case of such bonds of its own as were barred by contract from such action.

[65] *Pollack* v. *Farmers Loan and Trust Co.* (157 U. S. 429); on rehearing, 158 U. S. 601 (1895).
[66] The Bond Buyer, April 30, 1938.
[67] Sidney Ratner, American Taxation, Norton, New York, 1942, p. 486.
[68] *Graves* v. *O'Keefe* (306 U. S. 466 (1939)).

The reciprocal immunity from taxation of the property and instrumentalities of Federal and State governments has been recognized in the constitutions of Australia (art. 144), Canada (art. 125), and Brazil (art. 10 of the old Constitution; arts. 20 and 23 of 1937 Constitution).

In Australia, however, the Privy Council held, in 1907, that the States were entitled to levy an income tax on the salary of a postmaster (*Webb* v. *Outtrim*, 1907, App. Cas. 81).[69] And the immunity of interest on Federal and State obligations from reciprocal taxation, although recognized in early court cases, has been denied in Australia since 1920 (*Amalgamated Society of Engineers* v. *Adelaide Steamship Co.*, 1920, 28 C. L. R. 129).[70] In Canada, as early as 1887, the Privy Council held that a nondiscriminating tax levied by a Province on a bank chartered by the Dominion was valid (*Bank of Toronto* v. *Lambe*, 1887, 12 App. Cas. 575). In 1937 Provincial taxes on the salaries of Dominion civil servants and Dominion judges were upheld (*Forbes* v. *Attorney General for Manitoba*, 1937, 53 Times Law Rep. 211; *The Judges* v. *Attorney General for Saskatchewan*, 1937, 53 Times Law Rep. 464).[71]

In Argentina interest on government bonds has been exempt from the income tax. However, the Ministry of Finance recently introduced a bill in the National Congress to make interest on Federal, State, and local bonds subject to the income tax.[72] The authors have not been able to ascertain whether or not this has become law.

(*c*) *Arguments concerning tax exemption.*

No useful purpose would be served by an extensive review of the arguments for and against tax-exempt securities. But a few of the highlights may be recalled. Perhaps the simplest statement of the opponents' case is that "Any exemptions of receipts by kind is clearly incompatible with the essential rationale of income taxes."[73] The issue is greatly sharpened by the war and the increases and proposed increases in progressive rates attending the war-revenue program. Under rates proposed by the Treasury in 1942, a tax-exempt security yielding 2½ percent would afford as much net income after taxes to a holder with a $100,000 income as a taxable security with a yield before taxes of 20.8 percent.[74] A huge reservoir of tax-exempt bonds now held by tax-exempt institutions could be purchased by private individuals. Individual holdings of such immune investments could be increased very substantially without further issue of State and municipal bonds.

More than half of the existing tax-exempt bonds have been outstanding 10 years or more.[75] The owners of these bonds may have sacrificed something in potential interest yield when they purchased these securities, but the rates of tax were relatively low then as compared with the present, and purchasers could not have rendered a fair equivalent in buying these privileges. A taxpayer with a

[69] J. L. Lewinsohn, "Tax-Exempt Salaries and Securities," American Bar Association Journal, vol. 23, September 1937, p. 689.
[70] J. P. Wenchel, "Some Thoughts Concerning Termination of Tax Exemption," Taxes, 16:11, November 1938, p. 655.
[71] Lewinsohn, op. cit., p. 689.
[72] Tax Administrators News, 5:10, October 1941, p. 116.
[73] Henry C. Simons, Personal Income Taxation, University of Chicago Press, Chicago, 1938, p. 170.
[74] Statement by Randolph E. Paul, tax adviser to the Secretary of the Treasury, before the Ways and Means Committee of the House of Representatives on tax-exempt securities, 1942, mimeographed, p. 2.
[75] Ibid.

$500,000 income from other sources who purchased a 4-percent tax-exempt bond in 1929 could expect a return on this bond equivalent after taxes to that on a 5.26-percent taxable security; under proposed 1942 Federal income tax rates, the equivalent would be a taxable security yielding 33⅓ percent.[76]

The proportion of large estates invested in tax-exempt securities has always been surprisingly low, but the proportion is rising,[77] and under present strong incentives an acceleration of this movement is to be anticipated. The degree to which the Federal Government has compromised its taxing power is clearly evident when it is considered what tax exemption would mean in the event that a wartime ceiling on income should be enacted.

Proponents of exemption removal also argue that tax-exemption produces undesirable nonfiscal effects, that it dissuades those who can afford to gamble from making risky investments, and dissuades those who need security from buying tax-exempt government bonds.

The revenue at stake in the tax-exempt security issue is substantial, though secondary in importance to the consideration of equity in the application of the income tax. At 1942 levels of business and proposed Treasury rates, the estimated loss of revenue from exemption is $275,000,000.[78]

Proponents of exemption fear that its elimination would adversely affect the credit of the States and municipalities, necessitate larger outlays for interest, and thus cause higher general property taxes.[79] It is also argued that the proposed change would involve a surrender of State sovereignty, a loss of independence, and a submission to new Federal control.[80] It is contended further, on behalf of security holders, that to subject existing State and local issues to taxation would be breaking faith.

As to the first of these arguments, the balance of gain and loss from the intergovernmental exchange of privileges is very obscure and depends upon many of the notorious vagaries and uncertainties in calculating the effects of tax exemption. While the advantage to States and municipalities in reduced interest costs, as a result of tax immunities for their bonds, is not subject to clear demonstration and has been categorically denied by some critics, it has been quite generally conceded that the exemption might cause a difference in interest rates ranging upward to one-half of 1 percent. During recent years, State and local bond issues have amounted to $1,000,000,000 per year, and if the volume should continue, extra interest payments might amount to $5,000,000 in the first year and eventually to as much perhaps as $100,000,000 per year.[81] This loss would be partly offset by any gains which the States might realize, were the States and their subdivisions allowed to tax Federal bonds.

That States and municipalities would find this a fatal impediment to credit operations or fiscal interests seems quite unlikely. These units managed very well without this advantage before the income tax was developed. State and municipal bonds commanded an excellent market and a considerable advantage over most other bonds

[76] Ibid, p. 3.
[77] Ibid.
[78] Ibid.
[79] Carl Chatters, statement before the Ways and Means Committee, March 27, 1942; The Bond Buyer, April 30, 1938.
[80] Fred R. Fairchild, statement before the Ways and Means Committee, March 27, 1942; Henry Epstein, "The Opposition of the Cities and States to Federal Taxation of their Securities," Proceedings of the National Tax Association, 1941, pp. 176–188.
[81] Randolph E. Paul, op. cit., p. 7.

in this earlier period. Moreover, governmental units manage quite successfully to obtain credit in Australia, Canada, and many other countries without immunities.

That the tax immunity is a concealed subsidy has been well explained by Edwin R. A. Seligman as follows:

> The constitutional inhibition, if it means anything, means only that the National Government shall not discriminate against the States by injuring their power to borrow. It does not mean that the National Government should discriminate in favor of the States by enhancing their power to borrow. A special exemption of State bonds from a general income tax would, if it increased the market price of these securities, be tantamount to a gift from the National Government to the State government. Such a relation, however, is not contemplated by the Constitution. It is not the function or the province of the National Government to confer gifts or favors upon the State governments. The States can look after themselves, and all they have a right to ask from the National Government is that there shall be no unconstitutional interference with their powers. Equality under the Constitution they have a right to claim; special favors they have no right to demand.[82]

The argument that the elimination of tax exemption would involve a dangerous shift of power to the Federal Government is rebutted by the proposition that no authority is sought to levy a discriminatory tax. But it is said that if Congress has the power to tax State and local securities it could tax some and exempt others. Of course, Congress already has the power to subsidize some local functions and not others through its subvention system. But if a shift of powers is at issue, the Supreme Court could take care of the matter by declaring the power to tax governmental instrumentalities (without discrimination) to be reciprocal. It is also alleged that if the door is opened to tax the interest on State and local securities, this will make municipalities liable to taxation on their public enterprises. But this does not seem to follow. There is a wide difference between the taxation of private individuals who own government securities and the taxation of government enterprises where no private parties are involved. Centralization of power is certainly not part of the purpose of those who seek to eliminate exemptions from the income tax.

The argument that exemption elimination, as applied to existing issues, is breaking faith with those who purchase securities in the expectation that the latter would continue tax-exempt has some validity. The validity is weakened by the vastly changed conditions that now prevail. Moreover, it will be 1970 before 90 percent of existing issues expire.

(*d*) *Problem of intergovernmental relations.*

Whatever may be concluded as to the merits of the argument concerning tax exemption of government bonds, there can be no doubt that the effort to eliminate this feature of our tax laws has met with constant, general, and bitter opposition from many State and municipal officials. It is quite unfortunate that the two issues involved in the elimination of tax-exempt securities have become so badly confused. The proponents of exemption elimination are not "out to deprive the municipalities of such limited fiscal advantages as the latter now possess." Nor do most State and local officials take any pleasure in serving as a "front" to protect the patently unfair privileges of rich taxpayers. Hope might be expressed that these two groups could get together on a program which would meet the objectives of both.

[82] E. R. A. Seligman, The Income Tax, 2d edition, Macmillan, New York, 1914, p. 614.

One compromise calls for a distribution to the States of the revenue collected as a result of the elimination of tax-exempt securities. The elaborate accounting and apportionment problems that this alleged solution would involve are so out of proportion to the revenue at stake that the proposal does not merit serious consideration.

Much more promising is the proposal to allow the taxpayer a credit against taxes roughly equivalent to the differential caused by tax exemption. If this credit were, in addition, subject to inclusion in the taxpayer's income for tax purposes, the result would be that the differential advantage of large taxpayers from the exemption would be wiped out. At the same time, some of the attractiveness of State and local bonds resulting from their special tax status would be preserved. This solution is attractive, but too complicated to be readily understood by the public.

A simple solution calls for a direct subsidy to units which borrow in the future. The equivalent of one-half of 1 percent on the outstanding principal of new bond issues could be paid to the issuing units annually by the Federal Government. This would have the effect of eliminating the inequities in the income tax created by tax exemption, and would convert a hidden and indirect subsidy into an open and direct one. To be sure, the subsidy might be resented because of its distribution according to the debt-incurring propensities of State and local governments, but the concealed subsidy of tax exemption is distributed in this manner now. It can hardly be doubted that this solution would be better than no action.

It is also suggested that the Federal Government might establish a Federal bank for States and municipalities, and that the bank might extend its credit to the units of government which sought such service. The bank itself would secure its capital from the sale of taxable securities to the public. There is precedent for such an arrangement in some of the countries of Europe, and Federal lending agencies have performed somewhat the same function in recent years. However, in this country, there is some doubt of the acceptability of a formalized institution of this sort by the States' rights proponents.

Whether or not any of these solutions is seriously entertained, the Federal Government might well appreciate that its own interest in the elimination of tax exemption calls for some generosity in dealing with the States and municipalities in other phases of fiscal policy. On the other hand, State and local officials should appreciate that they too have some stake in the equity and adequacy of the Federal tax system.

The most desirable solution of the tax-exempt-security problem would be the elimination of tax exemption. If a compromise is necessary to secure action and promote better intergovernmental relations, and such seems to be the case, a direct subsidy equivalent to the indirect one now allowed to borrowing governments is recommended.

B. TAX ADMINISTRATION [83]

1. INTRODUCTION

Two propositions concerning administration are very common in the literature of tax coordination. The first is that overlapping

[83] For a more complete analysis, particularly of the substantive problems of Federal and State tax administration, see the special monograph prepared for this report by James W. Martin. This section is based in part on his monograph.

State and Federal taxes involve substantial waste in unnecessary costs of tax administration and taxpayer compliance. The second (acceptable only with qualifications, as indicated later) is that taxation is no exception among the functions of government in the application of the rule that the level of government which can perform the task most efficiently should be the one to which such task is delegated.

Unfortunately, data on both cost of administration and cost of compliance are difficult to obtain. It is an indication of the degree to which the coordination movement has confined itself to the verbal sphere that no one has ever undertaken to assemble complete and authoritative cost data.[84] Any agency, either of a fact-finding or administrative character, to whose lot may fall the responsibility of further work in the field of intergovernment fiscal relations, should, in our judgment, consider this as research project No. 1. This recommendation cannot be urged too strongly.

2. COSTS OF ADMINISTRATION

At the request of our staff, the Bureau of Internal Revenue submitted the following estimates concerning the cost of administration of Federal taxes (table 25, below). The Bureau does not maintain a cost-accounting system by which precisely accurate figures can be obtained. However, every effort was made to allocate properly the total cost of the Bureau among the various classes of collections.

TABLE 25.—*Cost of collecting Federal taxes (statement showing by class of tax the total internal revenue receipts; the total amount expended and obligated, and the cost of collecting each $100 of revenue)*

Class of tax	Internal revenue receipts, fiscal year 1941	Expended and obligated, fiscal year 1941	Cost of collecting $100 of taxes
1. Income and profits taxes:			
Individual	$1, 418, 382, 771. 51	$23, 874, 805. 43	$1. 68
Corporation	1, 860, 355, 907. 17	13, 233, 285. 41	. 71
Excess profits	192, 385, 251. 89	1, 870, 526. 31	1. 00
Total income and profits taxes	3, 471, 123, 930. 57	38, 987, 617. 15	1. 12
2. Employment taxes	925, 856, 480. 38	6, 329, 216. 49	. 68
3. Capital-stock taxes	166, 652, 639. 88	842, 202. 80	. 51
4. Estate and gift taxes	407, 057, 747. 52	2, 099, 622. 40	. 52
5. Alcoholic beverage taxes	820, 056, 178. 33	13, 640, 954. 52	1. 66
6. Tobacco taxes	698, 076, 800. 87	1, 241, 285. 07	. 18
7. Stamp taxes	39, 056, 960. 09	245, 184. 90	. 63
8. Manufacturers' and retailers' excise taxes	617, 353, 891. 64	589, 738. 72	. 10
9. Miscellaneous taxes	224, 873, 672. 38	1, 313, 704. 95	. 58
Total, all taxes	7, 370, 108, 377. 60	65, 289, 527. 00	[1] 1. 89

[1] Average.

Source: Memorandum from the Bureau of Internal Revenue, Jan. 5, 1942.

The data submitted in table 25 are impressive in a number of respects. In the first place, the over-all cost of administering all taxes, eighty-nine one-hundredths of 1 percent, is impressively low. Second, none of the major specific taxes shows a cost-of-administration figure which could be called excessive. Even the personal income

[84] The authors conceived this to be one of the most important contributions that could be made in the present project. The effort to assemble a complete picture of costs of administration has been reasonably successful (though not all that was hoped for). A project to ascertain costs of compliance was set up in cooperation with the U. S. Department of Commerce. It was proposed to secure the cooperation of industry in a thorough week-to-week check of costs of operation devoted to taxation. The work was to be carefully supervised to make certain that uniform accounting practices were followed in the tabulation. Special attention was to be given to the additional cost of State tax compliance assuming the corresponding Federal taxes to be already in the picture. A sufficient sample was contemplated to cut across the entire field of corporate industry in the United States. It was a keen disappointment to the staff that this project had to be abandoned, because of the war.

tax with its elaborate law and equally elaborate machinery of administration and collection shows the relatively moderate figure of 1.68 percent. To be sure this does not include all the considerable cost of the machinery of litigation, much of which is borne by the Department of Justice and the courts. Moreover, the figure makes no allowance for the additional cost which may attend the broadening of the income-tax base in 1942. If this new task assigned to the Bureau is to be performed with the costly and not always lucrative policing that it deserves, the cost-of-administration figure may rise substantially. But it can rise quite substantially without reaching a level which could be called excessive. The third and final observation is that certain of the excises, notably that on tobacco, have administration costs which are almost unbelievably low. The figure, however, is not at all difficult to explain. The administration is highly centralized and most of the collection is from a few large companies. A mere handful of men is sufficient to perform the task of collecting a sum of $698,000,000. Table 26 shows the trend in the over-all cost of Federal collections in recent years. The influence of wartime rates and yield can be observed in the drop for 1941.

TABLE 26.—*Cost of collecting the Federal Internal Revenue, 1934–41*

	Total taxes collected	Cost of collecting $100 of taxes		Total taxes collected	Cost of collecting $100 of taxes
Fiscal year—	*Thousands*		Fiscal year—Continued.	*Thousands*	
1941	$7,370,108	$0.89	1937	$4,653,195	$1.12
1940	5,340,452	1.12	1936	3,448,571	1.39
1939	5,181,574	1.13	1935	2,773,213	1.54
1938	5,658,765	1.03	1934	2,300,816	1.25

Source: Secretary of the Treasury, Annual Report, 1941, p. 222; 1940, p. 321; 1939, p. 145; 1938, p. 156; 1937, p. 146; 1936, p. 138; 1935, p. 110.

Available data on the cost of administration of State taxes are notoriously fragmentary, ill-defined, and unreliable. This state of affairs has been attributed to "a general lack of interest in the whole subject of administrative costs." [85] This observation is highly significant in view of the fact that the cost of the tax mechanism is a major consideration in the case for tax coordination.

The fragmentary character of the data limits their usefulness because administrative costs for "cycle-sensitive" taxes, such as the income tax, should vary substantially with total collections which, in turn, vary with the character of business conditions. Unreliability is due to the fact that cost figures are frequently estimates, not to say guesses, and are based upon little careful check of joint-cost outlays. Sometimes overhead items, such as financial control, personnel administration, and legal services, are omitted entirely. Inheritance-tax figures, for instance, usually include only cost at the State level omitting (without so stating) important local costs. Ordinarily rents are omitted entirely from the calculation; machinery and equipment costs are frequently allocated badly. A majority of the departments charged with collecting more than one tax are not able to separate costs by individual taxes. Often very special State conditions account for the fact that particular figures are out of line. On the other hand, some States, such as Utah, do a thorough job of cost analysis.

[85] Thomas J. Reynolds, "Cost of Administering the Various State and Local Taxes," Studies in Current Tax Problems, Twentieth Century Fund, New York, 1937, p. 138.

It should be observed that all cost-of-administration data tend to be misleading, at least if they are not qualified with substantial qualitative explanation. They cannot be accepted at their face value as indices of efficiency in administration. Beside the factor of administrative efficiency involved, these data are influenced by the following additional factors: (1) Administrative policy, i. e., the degree of thoroughness to which the policing role is pursued; (2) the rates of tax; (3) richness of the tax base (also degree of business prosperity); (4) accounting practice in the distribution of such items as legal expense, capital outlays, local services, research and statistics; (5) lag in administration; and (6) time the tax has been in effect.

Cost data need interpretation in the light of circumstances prevailing in each State. High costs, for example, may be due to bad administration, thorough administration, or a high ratio of necessary overhead to a narrow tax base.

Table 27 presents the best available data concerning cost of administration of State and local taxes. In interpreting these data, attention should be given to qualifications already discussed and to those presented in the footnotes. Particular attention is called to the presumption that the death and gift-tax and tobacco-tax estimates are far too low; the first, because important items of local expense are omitted; and the second, because discounts allowed for the cost of affixing stamps are excluded.

TABLE 27.—*Estimated costs of administering various State and local taxes, 1941*

Tax	States for which cost data are available			All States	
	Tax receipts (thousands)	Costs (thousands)	Average cost of collecting $100 of taxes	Tax receipts (thousands)	Estimated total costs (thousands)
Alcoholic beverage	$124,491	$3,702	$3.00	$259,040	$7,771
Amusement			[1] 2.90	24,108	[1] 1,678
Bank			[2] 5.00	18,421	[2] 1,678
Chain store	394	21	5.30	5,020	266
Death and gift	56,784	1,039	[3] 1.80	116,351	[3] 2,094
Employment	513,027	5,572	1.10	891,018	9,801
Franchise or corporation license			[4] 1.60	105,541	[4] 1,678
Gasoline	464,959	2,328	.50	934,337	4,672
Income	311,338	4,809	1.50	408,869	6,133
Insurance premium			[5] 4.80	[5] 89,033	[5] 4,291
Margarine			[1] 3.20	552	[1] 75
Miscellaneous and licenses			[6] 6.00	[6] 420,000	[6] 25,200
Motor vehicle			[7] 8.00	438,427	[7] 35,226
Poll (State)			[2] 10.00	7,346	[2] 75
Property	397,652	8,446	2.10	4,969,897	105,362
Sales	452,592	9,156	2.00	545,594	10,912
Severance			[8] 1.00	56,571	[8] 75
Soft drink			[1] 1.30	4,426	[1] 75
Stock transfer			([1])	19,565	[1] 75
Tobacco	82,797	1,190	[9] 1.40	106,374	[9] 1,489
Total	2,404,034	36,263	[10] 1.50	9,420,490	218,626

[1] Based on experience in 1 State. In the case of the stock transfer tax, the average costs of administration were $0.04 per hundred dollars of revenue collected.

[2] Rough approximation based on best available information.

[3] Does not include important items of local expense.

[4] Based on experience inadequately reported for 9 States.

[5] Based on experience inadequately reported for 16 States.

[6] Rough approximation. Local nonproperty taxes are included, since there is no available basis for accurately estimating the cost of their administration. It is estimated that these revenues amounted to approximately $390,000,000 (in comparison with $354,590,000 reported in Bureau of the Census, Financial Statistics of State and Local Governments, 1932).

[7] Based on data covering practically all States, mainly for 1941, but probably inadequately separated from regulatory costs.

[8] Based on experience in 4 States.

[9] Excludes the important discounts allowed for cost of affixing stamps.

[10] Computed from data gathered directly from the States.

Such data as are available,[86] interpreted with the above limitations in view, support the following generalizations:

1. In few, if any, cases of overlapping taxes can the States administer their laws as efficiently in terms of a ratio of outlays to collections as can the Federal Government.

Federal administration costs are lower in cents per dollar of revenue than are those of the States in practically all cases in which direct comparison is possible, for one or more of the following reasons: (*a*) Federal rates are higher so that a given expenditure will yield more revenue; (*b*) Federal statutes are so drawn as in some cases to "skim the cream" only, as illustrated by the Federal estate tax which excludes from its scope the multiplicity of small estates covered by the average State; (*c*) Federal administration avoids the expense of State boundary problems as under the corporation income tax; (*d*) the Federal tax can apply at a point in the distributive process which is more economical administratively, especially in the case of the selective excises.

2. Among State taxes, the major ones that tend to be expensive to collect are the tobacco taxes (not all the costs are covered in table 27), automobile-license tax, and alcoholic-beverage taxes; those that tend to be inexpensive are gasoline, income, and property taxes.

3. The taxes in which the comparative advantage of the Federal Government seems to be greatest are death, alcoholic beverage, and tobacco taxes; the comparative advantage is not very great in the case of the gasoline tax, and some of the difference in the latter case is due to State provisions allowing exemption for gasoline used off the highways.

4. In no case of a major tax, except perhaps that of motor-vehicle taxes and death taxes and tobacco taxes in some States, do the combined Federal and State costs of administration and collection of overlapping taxes amount to more than 5 percent. Although a coordination program which might conceivably cut these figures in half would certainly be well worth an investment of effort, it should be remembered, in the interest of a realistic and well-balanced view of the matter, that the waste here involved can hardly be greater than that in many phases of government.

Administrative efficiency is not only a matter of ratios of cost to collections but also of the effectiveness of collections. It is commonly observed among tax administrators that the first 90 percent of any tax is likely to be forthcoming to the public treasury with little outlay for administration. It may well be, however, that the social interest requires an investment in tax administration well beyond the point of diminishing returns. Tax administration is a policing job as well as a means of collecting revenue, and the justice of effective tax collections has value in terms of public morale and may even be an end in itself.

3. COSTS OF COMPLIANCE

It has been recognized for some time, but only recently emphasized, that cost of administration is only one part of the cost of the tax mechanism. The other part is the cost of compliance. Unfortunately, as previously stated, the information available concerning this cost is inadequate. The principal available study of this subject is

[86] Including not only that presented in table 27 but also that for specific taxes presented in chs. VII and VIII.

that of Robert Murray Haig, with assistance from the Council for Research in the Social Sciences of Columbia University and from the American Management Association in 1934.[87] The study has been quite properly described as "a pioneering expedition into unexplored territory." It consisted of a fairly elaborate questionnaire requesting business concerns for information on compliance costs, segregated for different taxes. A large percentage of the questionnaires were not returned, and of those which were returned a large percentage were doubtless rough estimates. The sample consisted of 163 corporations that responded in detail to questionnaires originally sent to 1,600 corporations. Most of the corporations contacted were large, and manufacturing was heavily represented. Without supervision, such a process is likely to develop inflated figures. A natural animus against taxes would seem sufficient to insure a fairly constant margin of error in favor of high costs. On the other hand, costs of compliance, being an integral part of the costs of accounting, may be overlooked as well as exaggerated. Haig concluded that "actual contact with the individual returns has led me to the belief that the costs of compliance are understated in more instances than they are exaggerated."[88] The fact that the study covered a depression era is very important. Tax costs are probably somewhat constant whereas income and tax payments fluctuate substantially. In addition to these limitations, the study had another shortcoming from the point of view of those interested in fiscal coordination. While the figures show a break-down in some cases between State and Federal taxes, it is not clear whether or not figures for the former represent additional costs resulting from the existence of State taxes. In other words, would an elimination of the State taxes result in a complete saving of the cost of compliance attributed to these taxes? In view of the necessity for very elaborate modern business accounts, would the complete elimination of all income taxes eliminate all compliance costs associated with these taxes? The questions illustrate the exceedingly difficult matters of cost accounting involved in the determination of a cost-of-compliance figure.

The reported figures on cost of compliance with tax laws were as follows:

State corporation income tax (median for a group of 76 corporations), 9.5 percent of tax.

Federal corporation income tax (median for a group of 95 corporations), 4.7 percent.

State sales tax (arithmetical average for a group of 91 corporations), 3.7 percent.

Property tax (arithmetical average for a group of 122 corporations), 1.04 percent.

Besides a possible bias in the estimate upon which these figures were based, the first two are heavily influenced by the fact that incomes were at low ebb in 1934. On the assumption that accounting costs are fairly constant, an improvement of 200 percent in income and 300 percent in tax would make a very substantial difference to the picture.

[87] Preliminary findings are given in Robert Murray Haig, "The Cost to Business Concerns of Compliance With Tax Laws," The Management Review, vol. 24, November 1935, pp. 323-333.
[88] Ibid., p. 326.

Even making all due allowances for the important elements of uncertainty and probable exaggeration in the above figures, they carry enough weight to make an impressive case for doing something about compliance costs. Presumably, the problem is greatest for corporations with a cosmopolitan business in many States and not a very heavy business in most of these States. Haig ascribes the general difficulty to the rapid development of various new and complicated forms of Federal taxation applying to business, together with the rapid expansion of the area in which many concerns operate. This may represent the exception rather than the rule among corporations.

Some indication of the nature of the problem was suggested in a study some years ago by a committee of the National Tax Association. The committee, appointed to study the effects of a diversity of laws, secured information from four large interstate corporations. One corporation, which was engaged in business in 27 States, reported that it was obliged to prepare and file 60 reports, each with some peculiar characteristics. Another, engaged in business in 35 States, testified that it paid 198 taxes, or an average of 6 per State, in 35 different forms, running from 1 to 13 taxes per State.[89]

Haig found in his study that the group of 163 corporations covered filed 31,100 primary tax returns (used as a basis of determining tax liability), 6,368 Federal and 24,782 State and local. This makes an average of 39 Federal returns and 152 State and local. These figures are exclusive of informational returns and other reports to tax officials totaling 160,000.

It should not be supposed that the cost-of-compliance problem is confined to corporations. While no data are available, it appears quite plausible that some persons paying a $50 personal income tax invest as much as a day in keeping and supplying income-tax information in which event a compliance cost quite as impressive as that reported by Haig may be involved.

Interest in cost of compliance is not altogether a matter of cutting expense. The attitude of the taxpayer toward government is very much involved in this problem. Taxpayer relations with government are frequently far from friendly and cooperative. Both the revenue and government suffer as a result. More than likely, the relations could be considerably improved were government to make a small investment for the taxpayer's convenience and economy.[90]

Increased attention to compliance costs in the framing of all tax legislation can be recommended. The simplified Federal income-tax return was a step in this direction. The recent removal of the requirement that Federal returns must be notarized is another.

Numerous opportunities to reduce compliance costs exist short of complete integration of taxes. For example, many differences in income-tax laws, regulations, and reporting forms involve no controversial questions of policy and can be liquidated through the cooperative efforts of interested tax administrators. Other States might well follow the lead of New York and Wisconsin, which have changed their information returns so as to permit payers to prepare both State and

[89] "Report of the Committee of the National Tax Association on Uniformity and Reciprocity in State Taxing Legislation," F. S. Edmonds, chairman, Proceedings of the National Tax Association, 1930, pp. 347-350.

[90] Further analysis of the problem of measuring compliance costs and some sample cases of actual cost experience can be found in the monograph by James W. Martin previously cited.

Federal slips in one operation. Income forms are also characterized by unnecessary diversity. Both individual and (especially) corporate filing could be simplified by reducing differences in the composition of the forms to those dictated by the laws themselves. And many legislatures will be ready, if only they are apprised of the offensive provisions, to eliminate those differences in the laws themselves which reflect accident rather than design. Most of the changes noted here will necessarily be by the States, although on such points as the notarization of returns, the Federal Government might well give in to prevailing State practice by repealing the notarization requirement. In any event, such modest cooperative efforts offer large returns in reduced compliance costs and increased taxpayer good will.

4. ADEQUACY OF ADMINISTRATION

It has already been suggested that cost figures do not tell the whole story of efficiency in administration. There is also the matter of adequacy of administration. The limitations in this regard may be a matter of whether administrators can perform their task well or do perform it well. For example, in the case of State tobacco taxes, the administrator has the definite limitation that he cannot tax interstate purchases of tobacco, except under a use tax which in many cases is not feasible of enforcement. This limitation is exceedingly serious and has been estimated in some cases to amount quantitatively to about 20 percent of the potential base.[91] The same limitation holds to some extent for the general sales tax and for special excises other than those on tobacco. It is least serious in the case of gasoline where interstate shipments direct to consumers are not very voluminous, and exchange of information affords a fairly adequate means of reaching such traffic.

Serious limitations upon the State administrator also occur in the case of the net income tax. Information at the source, for example, is not directly available to cover interest and dividends received from out-of-State payers who are not doing business within the taxing State. However, in this case the desired information can be obtained either from the Federal returns or in some cases by an exchange of information among State administrators.

The States need have no serious necessary shortage in the basic data essential for the administration of the death tax.

Attention may now be given to the question of limitations in administration which are due to unnecessary imperfections in institutions. Here the Federal Government has some disadvantages, owing to its distance from the individual and its unfamiliarity with local conditions. In the case of the income tax, for instance, the Federal administration has never developed adequate means of checking its coverage of many small taxpayers, such as small business and professional men and farmers, about whom no disclosures are found in the voluminous supply of information at the source. In this respect the best State administrations are definitely superior, and the Federal Government has much to learn from them. On the other hand, the States have the frequent limitation of underpaid personnel, in most cases unprotected by civil service safeguards.

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91 See pp. 501-02.

Administrative staffs, both Federal and State, should be on a merit system from top to bottom. The Federal Government has not always set the States a good example in this respect. The collectors of internal revenue and, until recently, their staffs, have been outside the civil-service system. As to the collectors—appointed by the President—this involves problems of coordination and integration within the Bureau, as well as the usual considerations of personnel administration. Both the Federal Government and some of the States are making progress in this field.

Weakness as to integration and coordination at the State level lies mainly in the propensity to divide tax administration among several agencies. While there has been a trend toward integration in State tax administration, it still remains true that in many cases—

> responsibility is scattered in hit-or-miss fashion among a number of administrative bureaus of uneven merit, where assessment and collection of important taxes are still conducted casually and ineffectively.[92]

Coordination within the Federal Bureau of Internal Revenue is also far from perfect.

In the case of death taxes, States are oftener handicapped by divided responsibility in administration and the frequent mixture of lay and legal authorities in the assessment of the tax.

As previously stated, none of these latter limitations is inherent. The Federal Government has moved closer to the taxpayer in its decentralization program under which much authority is lodged in the 38 divisions of revenue agents (auditors in the field) and the 10 divisions of the technical staff; it has also made progress in the recent requirement that the staffs of collectors are henceforth to be selected under merit competition; and States have made some progress in the integration of their tax administration and the quality and tenure of personnel.

Beyond considerations of administration, there are certain considerations of suitability which need to be weighed in the determination of the levels of government best adapted to levy and administer the specific taxes. Among these are the difficulty of determining the jurisdiction to tax, the instability of yield, and the mobility of the base. These matters will be discussed in their proper places later.

5. CONCLUSIONS

Attempting to draw a few generalizations from what has been said thus far, one may state certain conclusions as follows:

1. Combined costs of administration and compliance, Federal and State, are quite sufficient, particularly as applied to Federal and State income, death, and business taxes, to warrant considerable effort to achieve a reduction.

2. State administrative costs for some taxes are high enough to warrant a presumption against State use of such sources of revenue unless other means of reducing the cost of the tax mechanism can be found.

3. State administrative disadvantages are quite pronounced for some taxes. They are particularly serious where the limitations are inherent and cannot be materially relieved by improvement in human institutions.

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[92] William Shultz, Essential Facts for Fiscal Policy, National Industrial Conference Board, New York, 1941, p. 125.

4. The Federal Government probably has a balance of advantages in the administration of all major taxes except the property tax and the motor-vehicle tax. The comparative advantage for some, such as the gasoline tax, is relatively small, while for others, like the tobacco tax, it is conspicuously high. If the fiscal independence of the States is to be maintained at even its present level, other interests than those of strictly administrative advantage must be weighed in the balance.

Moreover, if the United States Government is assigned greatly increased responsibility for tax administration, it is, by the same token, accorded greater control of expenditures or other disposition of the funds unless perhaps under a plan of State levy with central administration. The decision as to which jurisdiction is most efficient must, if it takes account of the relevant factors, look to the efficiency of control of the purse strings as well as efficiency of technical tax administration. But how well the Federal Government spends money, whether directly or through distribution to the States, can be decided only in terms of how it is believed money *should* be spent. In brief, the question is not one of technical efficiency but of political philosophy. If the proposal to make the assignment of particular tax administration functions to that jurisdiction which can best perform "the function" envisages "the function" as including spending the money or distributing it to the States to be spent, then the concept is too complicated to be very helpful as a matter of practical policy making. Many businessmen, for example, have suggested in conferences on the point that efficiency or expense of compliance are both small matters in comparison with the great amount of tax revenues the central government can waste by using a billion or two more than is essential for a Work Projects Administration program, by constructing a battleship when with better planning it could have been anticipated that an airplane carrier was needed instead, or in providing an Agricultural Adjustment Agency program of grants at great expense after the need for farm readjustments had disappeared. By the same token, if money is distributed to States, the fear of granting more than enough to some States so that others may not have a fair share, is a lively one.

Consequently, the proposition, "Tax administration like any other function of government should be assigned on the basis of efficiency of performance" [93] cannot be accepted without qualification.

The very substantial possibilities of further intergovernmental collaboration in administration and the development of joint administration or delegated administration have been discussed in an early section.[94] It has been suggested that this approach to the coordination problem is very promising indeed.

C. Governmental Reporting

1. Introduction and Importance

A phase of intergovernmental fiscal relations which usually receives less attention than it deserves is that of statistical reporting. To operate a modern governmental system without substantial information concerning the operating parts is like running a modern business without an efficient accounting system. Municipal accounting and

[93] Simeon E. Leland, State-Local Fiscal Relations in Illinois, University of Chicago Press, Chicago, 1941, p. 6.

[94] See pp. 141ff.

reporting is valuable to show those interested in the municipality where it is going and what it can do, "to facilitate comparisons between units, and to build up an over-all picture of the financial operations of government." [95] Knowledge is not wisdom in government or any other human undertaking. But neither can good decisions be made in a vacuum without adequate information. A certain amount of basic data is required as the raw material for inquiry. Much is heard these days about "a new era of planning." The first step in planning is to seek a picture of the existing situation.

2. QUALIFICATIONS OF GOOD REPORTING

It has been suggested [96] that a good reporting system should have the following characteristics:

(1) It should provide comparable data as to definition and classification. If one property tax figure includes penalties and interest and another does not, comparisons are impeded.

(2) It should include adequate detail. It would seem that in this day of extensive governmental operations, data as to costs, receipts, capital outlays, debt, and governmental transfers with appropriate break-down might be expected.

(3) It should be synchronized as much as possible. Differences in fiscal years, some, perhaps, unavoidable, impede comparisons and cause delays.

(4) It should be prompt. Information loses much in usefulness if it is long delayed in process.

(5) It should make its results available to interested parties. The United States Census Bureau would have its task greatly facilitated if duplicates of municipal reports could be sent directly to it. A precedent for this procedure exists in the field of vital statistics.

3. INADEQUACIES OF THE PRESENT REPORTING SYSTEM

Governmental reporting in the States is in a sad condition of underdevelopment and neglect.[97] Ten States have local governmental reporting that is comprehensive; 11 States collect no information concerning municipal receipts, payments, or debts. The number of States publishing at least 1 or more items on municipal receipts is 21; on municipal payments, 14; on municipal debt, 23. County receipts are reported by 29 States. One or more figures on county payments are reported by 23 States, and 1 or more figures on county debt by 30 States. In the case of Florida, no official figures on city revenues and expenditures are available prior to 1930 or subsequent to 1935, and those available between 1930 and 1935 are incomplete because they do not cover all cities. These figures can in some instances be obtained by extracting them from the accounts and records of each individual municipality. Special districts do not report. Data for the State and school districts are both available and good, and those for counties are improving.[98] In a bibliography of State grants-in-aid published recently by a State tax commission, only 28 States were listed as having annual reports of a sufficiently comprehensive nature to let their citizens know the principal grants given by

[95] Henry F. Long, "The Case for a Minimum State System of Local Government Reporting," State Supervision of Local Finance, Proceedings of a Conference, December 4, 5, 6, 1941, Municipal Finance Officers Association, Chicago, pp. 55-61.

[96] E. R. Gray, "Nation Wide Statistics of Local Government," ibid., pp. 61-65.

[97] Ibid., p. 62.

[98] The Florida Fiscal Situation, A Preliminary Study by a Survey Committee of the Brookings Institution, for the Tax Inquiry Council of Florida, 1941, pp. 88-90.

those States to their respective "governments." [99] Even where data are available they are usually in many respects not strictly comparable.

Among the most important factors in the incomparability of State-reported data are—

differences in fiscal years; differences in methods of allocating overhead or administrative costs to constituent activities; differences in definitions and use of terminology; and variations in the classifications and subclassifications devised to present details of an account or activity.[1]

The Census Bureau's annual compilation of financial statistics of cities has been confined to data on large cities, recently those with population over 100,000. Recently annual information concerning debts of all governments has been provided. Data for States as such are compiled and published annually. A study of wealth was formerly made and published decennially.

Since public collection of such data has been inadequately supported, private collection efforts have entered to fill the breach; these have resulted in much-needed information but also in confusion and duplication. These private efforts have been financed by philanthropic organizations, profits from the undertaking, or by emergency funds from the Government. In some cases the private reports have been inadequately documented as to methods and sources. On the other hand, centralized governmental reporting is also criticized for tardy publication, insufficient analysis of findings, and inertia.[2]

State reporting is intimately associated with the problem of public accounting. Adequate reporting tends to promote adequate accounting and vice versa. Provisions for uniform accounting and the auditing of municipal accounts differ substantially from State to State.[3]

4. WHAT IS BEING DONE TO IMPROVE GOVERNMENTAL REPORTING

The field of intergovernmental financial statistics is obviously one which requires exercise of the arts and techniques of cooperation and persuasion. Until recently very little of a promotional character has been undertaken to improve the level of State and local reporting. Recently the Census Bureau has sponsored conferences of State officials in Washington to create interest in a cooperative attack on the problem. One of these conferences appointed a committee to draw a model State law for compulsory municipal reporting.[4]

The committee was given the mandate to cooperate with the national committee on municipal accounting of the National Municipal Finance Officers' Association. Efforts of this sort need definitely to be encouraged. The Census Bureau has solicited criticism of its techniques from those in the field who use its services and are in a position to know the shortcomings of its work.

[99] E. R. Gray, "Deficiencies in State and Local Government Data," Annals of the American Academy of Political and Social Science, vol. 207, January 1940, p. 197.
[1] Ibid., p. 198.
[2] Ibid., p. 201.
[3] State Supervision of Local Finances, passim.
[4] Ibid., pp. 72 and 73.

5. SUGGESTIONS

A more aggressive program of Federal promotion of adequate governmental reporting seems in order. Federal interest in the adequacy and the availability of governmental information is very great and increasing. Federal funds might be made available to provide some field work in this area. They might even be made available to pay for half of the cost of installing and/or operating systems which meet adequate specifications. They certainly should be made available to support a more extensive compilation and publication of basic financial information.

Three agencies at present maintain special library service in the field of intergovernmental problems: the Library of Congress, the Census Bureau, and the Council of State Governments. The council is somewhat insecurely supported, in part by private funds. The other two agencies are strictly Federal and inadequately specialized in one case and too much so in the other. It appears that a Federal-State agency could perform a very constructive service by the development of a new research and informational service. It could supplement the Council of States as a clearing house for intergovernmental information. It could stimulate research in the field of State and local government by State and municipal universities. This might help to revitalize local governmental institutions now in some cases moribund because the idea prevails that all important civic affairs are centered in Washington.

D. COMMUNITY PROPERTY

A unique phase of the problem of intergovernmental fiscal relations arises from the diversity of State laws concerning property ownership, which precludes the uniform application of a nation-wide scheme of taxation. This is the problem of community property and its effect on the application of the Federal net-income and estate tax. Community property laws differ from State to State, but their essential feature is that the earnings and acquisitions flowing from the economic activities of husband and wife, and income and profits from community property, are jointly held. The husband, under these laws, ordinarily has in fact and in law a very large element of separate power of control. At death one-half of the community property becomes the separate property of the spouse; and the other half is subject to disposition and is taxable under the State death tax. Until this loophole was closed by the 1942 Revenue Act, half of the community property also escaped the Federal estate tax.[5] The same rules govern the division of income for income-tax purposes; that is, each spouse may report half of the income from community property or activity for State (and Federal) income-tax purposes.

Community property laws apply in nine States: Arizona, California, Idaho, Louisiana, New Mexico, Oklahoma, Texas, Wyoming, and Washington. In States where community property does not exist, each spouse must report his or her earnings and the income from his or her property independently. "The result is, to say the least, a deplorable discrimination."[6] Oklahoma recently amended its property laws with the quite deliberate purpose of reducing the tax

[5] Randolph E. Paul, Federal Estate and Gift Taxation, Little, Brown & Co., Boston, 1942, vol. 1, p. 53.
[6] Ibid., pp. 61-62.

liabilities of its citizens.[7] Attention was called to the fact that as much as $11,380 could be saved to those who might, by means of the new law, divide an income of $100,000.[8] The Bureau of Internal Revenue has refused to recognize the amendment for Federal income-tax purposes.

The situation is complicated by the fact that it is not entirely clear as to how far Congress might go in disregarding State concepts of property in the application of its tax laws. The income-tax discrimination could be removed by amendment requiring joint returns of income by husband and wife; or by a provision to create and apply a Federal rather than local rule in the application of the income tax to husband and wife; or by requiring all members of the family to sum their income, divide by the number of members, compute the tax, and multiply by the number of members. Territorial discrimination could be largely eliminated by providing that State community-property modifications of the common law shall not apply in the operation of Federal taxes. While it is not entirely certain, the probabilities are that Congress has the power to do this. Thus far, Congress, which considered income-tax modifications of the sort suggested above in 1937 and 1941, refused to face the problem, but it has broken the ice in the estate-tax field. It is recommended, accordingly, that Congress enact further legislation which would disregard these major differences in State property-ownership laws for purposes of Federal taxation and thus seek to establish the uniform application of its tax system. Geographical discrimination in the application of two very important tax laws was never contemplated in the enactment of these laws and should no longer be tolerated.

E. Impact of the War Upon State and Local Financing [9]

1. Present Condition of State and Local Finances and Future Outlook

The finances of State and local governments, and especially those of State governments, have thus far improved considerably as a result of the defense and war programs. The fiscal affairs of local governments also appear to be improving, but the situation is spotty, and some cities have been adversely affected. None of the State and local governments has as yet experienced the full effect of war taxes and rationing upon its revenues. The possible effects of inflation and post-war readjustments are also important.

Table 28 shows that State tax collections in 1941 were 8.4 percent greater than those in 1940. All sales taxes increased 11 percent (general sales taxes 15 percent); unemployment compensation taxes increased 7 percent; specific business and occupational taxes, 4 percent; net income taxes, 18 percent; motor vehicle licenses, 8 percent; and property taxes fell 2 percent. These six taxes normally account for some 95 percent of all State collections. The income tax supplanted the motor-vehicle-license tax as the fourth ranking State tax source.[10]

[7] Harry A. Campbell, "Developments Relating to the Oklahoma Community Property Act," The Journal of the Oklahoma Bar Association, February 28, 1942, pp. 49–57.
[8] Ibid., p. 50.
[9] Written in the summer of 1942.
[10] Bureau of Census, State Tax Collections: 1941, February 27, 1942, pp. 5, 15.

TABLE 28.—*Comparison of 1940 and 1941 State tax collections by type of tax*

Type of tax	Amount collected		Percentage change, 1940 to 1941
	1941	1940	
Total collections:	*Millions*	*Millions*	
Including unemployment-compensation taxes	$4,498.7	$4,148.8	8.4
Excluding unemployment-compensation taxes	3,597.3	3,305.2	8.8
General and selective property taxes	257.6	261.9	-1.7
Severance taxes	58.8	51.8	13.5
Sales taxes	1,821.8	1,643.4	10.9
General sales	565.9	491.0	15.3
Motor-fuel sales	914.5	846.0	8.1
Alcoholic-beverage	215.5	191.6	12.4
Tobacco	107.2	97.3	10.2
Soft drinks	4.2	3.3	27.3
Admissions	5.5	5.0	10.0
Other commodities	8.9	9.0	-1.1
Motor-vehicle licenses	417.1	387.2	7.7
Taxes on specific businesses	447.7	429.9	4.1
Corporations	101.2	92.3	9.6
Public utilities	106.7	111.6	-4.6
Insurance	103.6	99.5	4.2
Chain stores	6.1	6.8	-11.5
Alcoholic beverages	58.0	58.7	-1.2
Amusements	3.6	3.6	1.0
Betting	19.0	12.9	47.3
Other businesses, including banks	49.5	44.5	12.4
Net income taxes	422.7	357.9	18.4
Corporation	163.2	126.8	28.7
Individual	215.7	197.8	9.0
Undistributable	43.8	33.3	31.5
Inheritance and estate taxes	119.2	116.4	2.4
Gift taxes	1.8	.8	44.5
Poll taxes	4.8	5.5	-12.7
Hunting and fishing licenses	22.6	20.7	9.2
Documentary and miscellaneous	23.4	29.8	-21.5
Unemployment compensation	901.4	843.6	6.9

Source: Bureau of the Census, State Tax Collections: 1941, Feb. 27, 1942, p. 15.

Increases in tax collections over 1940 were noted in all but four States. The decreases in Arizona and Delaware were less than 1 percent, but the more substantial decreases in Minnesota (1.87 percent) and Nebraska (13.3 percent) were probably due in part to lowered unemployment compensation taxes, following adoption of experience ratings.[11] Increases ranged from fractions of 1 percent in South Dakota and New Hampshire to over 18 percent in Michigan. Most spectacular increases were noted in war-industry areas and in those States heavily dependent upon sales taxes (Michigan, Virginia, Ohio, Alabama, Florida, and Georgia).

For the year ended June 30, 1941, State and local gross debt decreased $42,000,000, a reversing of the moderate pre-war expansion.[12] New borrowing will fall off sharply and a slow rate of debt retirement may be achieved.

Although revenues to June 1942 are even better than those of the record 1941 period, it cannot be expected that this rate of increase will continue throughout 1942 and 1943, since the prospects are for a decline in gasoline-tax and motor-vehicle-registration collections under curtailment of automobile travel, and of sales tax under the

[11] Ibid., p. 8.
[12] Bureau of the Census, State and Local Debt: 1941, April 1942, p. 3.

influences of rationing, durable consumer goods curtailment, and price control. Liquor licenses and other liquor revenues may also decline at a later date under liquor control and diversion of alcohol. Federal taxes at higher rates will also have effects upon the ease of collection and the yields of many State taxes. Those States in which personal and corporate income taxes and other business taxes are relied upon extensively are likely to be less seriously affected, particularly if they include war industry or related enterprise and do not allow Federal taxes as a deduction in computing their own taxes.

Motor-vehicle tax revenues are already decreasing, and a 35-percent drop for 1943 from 1941 levels is probably a conservative estimate. Motor-fuel tax collections in May 1942 for 43 States showed an average decrease of 9 percent from May 1941.[13] Receipts are steadily declining in the rationed States. Motor-vehicle taxes are the most important single source of revenue for States and are of considerable importance for local governments. Highway expenditures by States, and to a lesser extent by their subdivisions (except where such expenditure is for servicing debt), can be and to a certain degree must be curtailed. States diverting motor taxes to general governmental expenditures (15 percent diverted) cannot thus escape the impact of this change.

Sixty percent of the expenditures on State highways are for construction, and these outlays can be reduced.[14] However, as shown in table 29, one-fourth of the States used over 30 percent of their gasoline taxes for debt service in 1940. A number of Southern States with a heavy per capita highway debt and limited alternative tax resources are in a difficult position.

TABLE 29.—*State highway indebtedness, highway debt service charges paid from motor-vehicle taxes, and percent of motor-fuel taxes allocated for servicing highway debt, 1940*

State	Highway debt outstanding [1]	Annual highway debt service charges paid from motor vehicle taxes [2]	Percent of State share of fuel taxes used to service highway debt [3]	Percent of local share of fuel taxes used to Service highway debt [3]
Alabama	$41,497,000	$2,627,000	15.3	
Arkansas	136,000,000	9,850,000	73.0	12.2
California	43,425,000	3,696,000		
Colorado	25,968,000	1,967,000	26.6	
Connecticut	14,668,000	1,987,000	15.0	
Delaware	9,275,000	655,000	19.4	
Florida	128,851,844	9,627,000	40.5	
Georgia	16,000,745	83,000	(4)	
Idaho	311,500	101,000	(4)	
Illinois	121,175,000	11,435,000		7.3
Iowa	87,692,550	8,302,000	44.0	
Kansas	19,945,309	1,335,000	11.4	
Louisiana	106,309,877	7,214,000	65.8	
Maine	28,432,000	2,770,000	31.4	
Maryland	16,724,000	1,404,000		12.7
Massachusetts	23,000,000	6,092,000	34.3	15.7
Michigan	47,419,000	4,081,000	15.9	

[1] American Association of State Highway Officials, American Highways, January 1940, p. 17. Figures for Arkansas and Maryland have been revised in accordance with more recent information.

[2] Computed from data shown in U. S. Public Roads Administration releases, tables G-3 and MV-3, 1940.

[3] Computed from table G-3 cited in footnote 2. The State's share represents only that portion of motor-fuel taxes allocated to State highway purposes, and excludes allocations for local roads and streets and for nonhighway purposes.

[4] Less than 1 percent.

[13] "90 Millions in Gas Taxes May Be Lost by States," Washington Star, July 20, 1942, p. 5.

[14] A. B. Goodman, "Effect of War Rationing on State and Local Revenues from Motor Vehicle Taxes," Committee on Federal-State-Local Fiscal Relations, Treasury Department, April 1942, p. 12.

TABLE 29.—*State highway indebtedness, highway debt service charges paid from motor-vehicle taxes, and percent of motor-fuel taxes allocated for servicing highway debt, 1940*—Continued

State	Highway debt outstanding	Annual highway debt service charges paid from motor vehicle taxes	Percent of State share of fuel taxes used to service highway debt	Percent of local share of fuel taxes used to service highway debt
Minnesota	$48,000,392	$4,273,000	...	...
Mississippi	36,300,000	3,523,000	$51.6	...
Missouri	94,990,000	8,869,000	37.8	...
Montana	4,500,000	947,000	18.2	...
Nevada	157,500	88,000	(4)	...
New Hampshire	7,970,000	1,148,000	25.2	$51.5
New Jersey	97,870,000	5,952,000	17.2	19.4
New Mexico	24,380,000	1,897,000	41.3	...
New York	194,530,000	11,819,000	36.5	...
North Carolina	80,055,324	8,788,000	25.9	...
North Dakota	600,000	...	...	...
Oregon	16,926,750	2,700,000	21.6	...
Pennsylvania	62,942,000	5,758,000	8.1	...
Rhode Island	5,087,000	245,000	8.5	...
South Carolina	59,576,200	2,750,000	21.9	...
South Dakota	...	2,000	(4)	...
Tennessee	110,215,800	3,528,000	43.6	...
Texas	89,002,853	7,287,000	24.5	...
Utah	1,000,000	118,000	...	...
Vermont	4,039,285	1,337,000	26.1	25.4
Virginia	3,428,000	221,000	(4)	...
Washington	8,346,000	350,000	2.5	2.0
West Virginia	76,212,000	7,939,000	44.7	...
Wisconsin	21,786,187	3,887,000	35.2	...
Wyoming	2,885,000	117,000	3.2	...
Total	1,917,495,116	156,768,000	18.2	2.9

[4] Less than 1 percent.

The expenditure situation is further aggravated by the fact that Federal works expenditures on highways, amounting to large sums in recent years, are being greatly reduced or eliminated. Also, restriction of normal Federal highway aid to 75,000 miles of defense highways, only one-third of the normal Federal-aid system, creates additional complications.

Proposals for Federal reimbursement of State motor-fuel tax losses due to rationing are considered premature. Improvements in other revenues, reduction in highway expenditures, rate increases in some States, and diversification of tax systems in others hold promise of offsetting much of the adverse effect. Impairment of debt service on highway bonds is not considered imminent, although highway aid to local governments will undoubtedly be curtailed.

Although construction expenditures of State and local governments will fall, and general relief loads (despite Work Projects Administration curtailments) may be considerably reduced, heavy costs for facilities in war-affected areas and general increases in costs of war activities, wages, salaries, and materials will be experienced. Basic public services cannot be greatly curtailed in most instances.

Collection of local property taxes has shown improvement, but here, too, adverse war-created effects are anticipated. The cessation of private construction, the restrictions of price and rent control, the exhaustion of private inventories, and the increase in federally owned and tax-exempt real property are among these anticipated adverse factors.[15]

[15] Albert W. Noonan, "Assessed Valuations in a War Economy," Municipal Finance, May 1942, pp. 43-46.

Tax rates in 1941 for cities over 30,000, continuing the trend of the previous 5 years, showed a small increase. The increases were mainly in the large cities and in areas of war production. In a number of small cities, towns, and rural areas, small rate decreases have occurred.

Farm real-estate values rose 7 percent in 1942. This increase represented the largest single year's recovery since World War I. Values are 9 percent below the 1912–14 base but 50 percent under the 1920 inflation peak. The future trend will depend to a large extent upon the future prices of farm commodities.[16]

Tax exemption of real estate acquired for Army and Navy establishments, of personal property of British-owned plants and plants of the Reconstruction Finance Corporation, of real and personal property of other Government-owned production facilities is serious for many localities. Receipts from local housing authorities in lieu of taxes are far below taxes, even when projects are converted to defense housing. Payments in lieu of taxes on federally owned Lanham Act defense housing have now been made mandatory. Sums are to be equivalent to taxes, with deductions permitted for Federal expenditures for facilities usually provided by local governments.[17]

The growth of industrial, military, and naval activity incident to the war program is making it necessary for some local governments in the war areas to provide added public-works facilities and to meet added costs of operation and maintenance. The resultant financial programs have been especially difficult in the communities that have been newly created as the result of the war program.

2. SPECIAL FEDERAL AID FOR WAR-AFFECTED AREAS

The governmental services required as a result of the war program are largely those which traditionally have been locally financed. However, local governments are frequently unable to meet these war-created needs promptly because their financial resources are limited. State governments in turn are of little assistance because many of the functions involved are traditionally considered to be outside the sphere of State activity. Moreover, State aids to local units are both inflexible and slow to reflect sudden changes in local requirements.

Much of the financial responsibility for war-created activities must of necessity fall to the Federal Government because the extensive interstate migrations of population and the concentration of war activity in some areas is the result of Federal decisions and because the availability of adequate local public facilities and services is essential to the effective prosecution of the war.

A total of $300,000,000 in Federal funds has been provided for discretionary loans and grants to local governments for war public works. With the present tendency toward temporary structures and direct Federal construction and lease of facilities, this sum is expected to be adequate. Because of the difficulty of balancing factors of local and Federal interest, of measuring local ability, and appraising the permanent value of the projects, the grants have been difficult to administer. But they have met an urgent need in many areas of suddenly enlarged population.

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[16] U. S. Department of Agriculture, "Farm Real Estate Values Show General Rise During Past Year," release of April 13, 1942.

[17] Public Law 409, 77th Cong., sec. 8.

Civilian defense appropriations of $100,000,000 will be of considerable assistance in the purchase of equipment but will fall short of absorbing present and prospective burdens of local governments in all vulnerable areas.

3. THE PROBLEM OF SURPLUSES

As a result of improved economic and fiscal conditions, some State and local governments are accumulating surplus revenues. However, considering the long-run outlook, it is unlikely that more than a few favorably situated States and municipalities will be embarrassed by a problem of wartime surpluses.[18] State surpluses will be increasingly required as a cushion for revenue declines and to finance emergency State and local expenditure.

A number of States have been using, or have proposed to use, surpluses to reduce deficits and pay off old debt. Some, such as Virginia, have confronted the impediment of noncallable debt. Others have discussed use of the money for State property-tax reduction, relief of local property taxes, aid to local units in meeting defense costs, sinking funds, capital-outlay reserves, rehabilitation of institutions, reserves for emergency relief and social services, loans to local government, working balances, and State war-emergency costs. New Jersey was entertaining a proposal for a $50,000,000 post-war reserve fund to be created from $4,000,000 a year of gasoline tax proceeds and $1,000,000 annually from alcohol taxes. The fund would be used for emergency relief and loans to local units in post-war years. It was believed that because of release of funds by retirement of highway debt, highway construction support would not be reduced from present levels by the gasoline-tax diversion. Funds were to have been invested in Federal war bonds and State and local securities. Gasoline rationing, however, may render the entire plan unworkable.[19]

Special legislation or constitutional amendment is required in some cases to establish long-term reserves and authorize investment in Federal securities. Connecticut, for example, must utilize surpluses for retirement of State bonds or deposit them in mutual savings banks. At the moment, the banks are reluctant to receive such deposits and bondholders reluctant to sell their holdings.

[18] Oklahoma estimated a surplus of $5,410,000 for June 30, 1942. Pennsylvania's surplus on May 31, 1942, was $12,760,005, but a $50,000,000 decline in revenue is anticipated for the new fiscal year (Bond Buyer, June 13, 1942, p. 6). Connecticut expected a surplus of $5,250,000 on June 30, 1940, despite an increase of $1,000,000 in State expenditures over the previous year. Connecticut corporation-tax collections exceeded the previous year's results by $5,000,000 and were largely responsible for the surplus. Although inheritance tax proceeds fell $2,000,000, liquor taxes rose $1,000,000, utility and railroad taxes $1,000,000, and cigarette taxes $250,000 (Bond Buyer, April 11, 1942, p. 48). By the end of 1941, surpluses were being reported by at least 18 States—Virginia, $12,000,000; Ohio, $26,000,000; Colorado, $761,000; New York, $7,000,000; etc. (ibid., February 27, 1942, p. 30). Indiana had a 1941 surplus of $17,000,000 and the estimate for the current fiscal year was $20,000,000 in June 1942 (ibid., June 20, 1942). June 30, 1942, surpluses of New York and Virginia are $54,000,000 and $17,000,000, respectively, amounts well in excess of budget estimates (ibid., July 4, 1942, pp. 4, 6).

[19] National Municipal Review, May 1942, p. 292. In Minnesota, the Governor's executive order set up a $10,000,000 war-construction reserve fund to be created from available balances, legislative appropriations from current taxes, and funds released by construction postponement. Legislation would be required to make such reserves binding (National Muncipal Review, July 1942, p. 399). The Indiana tax study committee suggested that a reserve fund be created from the State's substantial 1942 surplus ($20,000,000) and invested in war bonds. The State was also urged to keep subsequent expenditures within revenues and not to permit the reserve to be used without special legislative authorization (Bond Buyer, June 20, 1942). In New York a post-war planning and capital reserve fund is established, to be created from nonrecurring revenues, some proceeds of bond sales, and some moneys from general fund surpluses (chs. 661, 788, 701, 636, 2081, 1942).

At the local level, even more legislative authorization is apparently necessary and it is becoming more and more unlikely that local units as a group will be able to accumulate substantial reserve funds for post-war construction in view of narrowly restricted revenue systems and increased costs. In many States, substantial changes in the law governing municipal budgeting and State supervision of accounts is required to authorize such long-term reserves and their investment in War bonds. During 1941, New York cities, villages, and first-class towns were authorized to create nontransferable reserve funds for capital improvements. Washington cities were also authorized to establish cumulative reserve funds for any municipal purpose. California and Oregon cities previously had statutory permission to set up reserve funds for public works.[20] The California law permitted municipalities to levy taxes several years in advance to raise funds for capital improvement construction and was considerably liberalized in 1941.[21] New Jersey authorized counties and municipalities to create public works reserves by appropriations for post-war capital improvements. Transfer of appropriations is forbidden. Appropriations are to be held in cash in capital account during the budget year. Money may be invested in United States bonds.[22] State legislation on local capital reserves is presented for illustrative purposes in table 30.

[20] Carl H. Chatters, "Finance Administration," Municipal Yearbook, 1942, International City Managers' Association, Chicago, 1942, p. 271.

[21] National Resources Planning Board, Long-Range Programming of Municipal Public Works, June 1941, p 32, and ch. 341, Laws of 1941.

[22] Ch. 187, Laws of 1942.

TABLE 30.—*State legislation on capital reserves* [1]

State	Citation	Units authorized to create reserves	Type of project authorized	Amount of levy	Within tax limits	Procedure	Time limit	Restriction on diversion
California	Ch. 717, Stats. 1937, as amended by ch. 341, Stats. 1941.	Cities, counties, or tax districts.	Any capital outlay	No limit	Yes, unless approved by ⅔ of voters.	Ordinance	None	Use may be changed by vote of ⅔ of electors.
Kentucky	H. B. No. 110, 1942.	School districts; cities of second class.	Purchase of school sites, building, or equipment; school buildings.	1 to 5 cents per $100 valuation.	No	Board action	do	Diversion prohibited.
Michigan	Ch. 223, Laws 1941.	School districts	Purchase of site, construction or repair of school buildings.	5 mills	Yes	Approval of electors.	5 years	No provision for change of purpose.
Nebraska	Ch. 12, Laws 1939.	Cities under 25,000; villages.	Specified projects	1 mill	No	Vote on levy and on improvement.	10 years	Use may be changed by majority of voters.
New Jersey	Ch. 187, Public Law 1942.	Counties, municipalities.	Any capital improvement undertaken following war.	No limit	Yes	Include in budget	To end of war	Not to be transferred out of fund.
New York	Ch. 747, Laws 1941.	Cities, villages, and towns of first class.	Any capital improvement.	do	No	Vote of electors if required for project.	None	Prohibited; unused balances may be transferred to other capital use.
Oregon	Ch. 140, Laws 1939.	Counties, school districts, cities, or towns.	Public-works projects.	do	do	Majority vote	5 years	By majority vote use may be changed.
Do	Ch. 333, Laws 1939.	Cities or towns	Purchase of fire-fighting, street, or other equipment.	do	Yes	Ordinance	None	Diversion prohibited.
Do	Ch. 122, Laws 1931.	Cities	Garbage and sewage-disposal plants.	5 mills	No	do	do	No provision for change of use.
Washington	Ch. 60, Laws 1941.	Cities and towns	Municipal capital outlay purposes.	No limit	Yes	do	do	Use may be changed by majority vote.

[1] Prepared by Ambrose Fuller, of the American Municipal Association, about July 1, 1942, and made available through the courtesy of Carl H. Chatters, executive director, Municipal Finance Officers Association, Chicago, Ill. Since this table was prepared, 10 additional States have adopted legislation on capital reserves.

As a rule, however, municipal budgets are restricted to a single year, and long-run reserves are prohibited except for bond sinking funds. Connecticut towns, for example, may not legally build up surpluses through taxation. Although the law is not always strictly enforced, towns have recently been obliged to apply surpluses to tax reduction in the subsequent fiscal period. Accumulations may legally be made only in bond sinking funds. By special legislation, one town has been authorized to build up surpluses, and these funds are restricted to capital expenditures.[23]

In the past, local cash reserve accumulations have been frowned upon by authorities on local budgeting as leading to extravagance, malpractice, and the withdrawal of too much money from circulation. Preference was given to the more usual form of pay-as-you-go financing on an annual budget basis. The public-works-reserve scheme for local units, while conforming to certain newer precepts for local wartime behavior, is not easily adapted to an overburdened property tax which traditionally has been levied on an expenditure basis. Local taxpayer groups can be counted on to oppose this procedure, and local officials will also be impressed by the lack of definite information as to the division of costs of post-war public works programs between National and local Governments.[24] Most important, however, is the doubt that many local units will be able to accumulate funds of sufficient moment to post-war programs to make any elaborate campaign for the scheme worth while.

The disposition of surpluses has an important bearing on the Government's efforts to prevent an inflationary price rise. These efforts would be facilitated if State and local governments used their surpluses to pay off indebtedness. Conversion of surplus to reserves would also be helpful, particularly if the reserves were invested in United States war bonds. The development of a nonnegotiable bond adapted to the needs of State and local reserve funds would stimulate the use of such funds and their investment in Federal securities.[25] Conversely, if improved State and local financial conditions resulted either in tax reductions or expenditure increases, the Federal Government's anti-inflation program would be handicapped.

State governments can facilitate the war effort, also, by extending financial assistance to war-created cities, which are required to provide essential governmental services to war industries and their workers. To date, very little responsibility has been assumed by States in extending special grants for emergency needs of local units in areas of wartime expansion. States and municipalities also can assist in the war effort by avoiding unreasonable requests for Federal aid. These units, along with the Federal Government, need to remember that their long-run interests are best served by the preservation of independent local self-government.

If all local governments were to cut taxes simultaneously, and the Federal Government were to increase its taxes by the same amount because of the decrease in local taxes, inflation would be largely unaffected and the revenue would be at the place where it is most needed.

[23] Bond Buyer, November 22, 1941, p. 32.

[24] Thomas H. Reed, Federal-State-Local Fiscal Relations, Municipal Finance Officers Association, Chicago, 1942, p. 16.

[25] This was written before the announcement of the recent security issues in the Victory fund program which goes a considerable distance toward meeting the needs of the States.

This would also enable the Federal Government to keep its debt at a minimum. The weakness in this solution is that not all of the States are likely to act simultaneously, nor is Congress likely to take their action into account. Consequently, the less States disturb their tax systems, the better for the counterinflation program.

States and municipalities can serve three objectives by surplus financing. This procedure will facilitate the anti-inflation program in which these governments have a direct interest. It will build a reserve which might be available for post-war contingency, and it will provide a hedge against possible loss of revenues resulting from wartime tax and control programs of the Federal Government. The second objective might be implemented by the development of plans (blueprint) for post-war public works. This program of surplus financing encounters several difficulties. In the first place, surpluses are not as common a phenomenon as some have seemed to think; and in the second place, surplus financing for State and local governments is full of pitfalls. Terms of State and municipal officials are often very short and surplus financing may mean handing a political rival a financial plum to dispose of according to his fancy. On the other hand, funds must not be so tied that they cannot be used in a genuine emergency. As already indicated, surplus financing at the State and local level is in need of further legislative implementation. In addition, if local interest and available surpluses are sufficient to warrant, the Federal Government might implement the program quite successfully by offering the States and municipalities a nonnegotiable bond, redeemable after the emergency or upon a showing of war-created need. The program might provide that if the bonds were retained and the funds used for approved post-war public works, the Federal Government would match the saving.

Probably the simplest and most practical solution of the surplus problem is the use of available funds to reduce indebtedness. In cases of noncallable serial bonds an effort can be made to induce existing owners to tender their holdings. Very often, too, it is possible to reduce the lag in State and local financing and thus eliminate short-term borrowing. New indebtedness can be avoided by financing current improvements out of current revenues.

4. STATE AND LOCAL INTEREST IN AVOIDING INFLATION

The Government's effort to prevent inflation is of vital importance to State and local governments. Experience during the last war indicated that an inflation can seriously disturb the equilibrium of State and local finances. Today the tax resources of these governments are more fully utilized than in 1917, and there is less scope for tax increases, especially in the field of property taxation. A severe inflation at the present time might render it extremely difficult to sustain State and local governmental services.

CHAPTER V

FISCAL POLICY

A. Introduction [1]

It is frequently contended that our entire revenue system needs to be overhauled in the light of the new needs and objectives of fiscal policy. It is frequently added that State and local taxation, particularly, is ripe for revision, and that the job should be done through changes in Federal-State-local relationships. Before considering this phase of our problem, it may be well to present a descriptive account of the trends and characteristics of the Federal, State, and local fiscal systems. Obviously, these accounts must be presented in outline, and confined to major, and rather general, observations.

B. Major Trends and Characteristics of the Fiscal System

Trends in tax collections are presented in table 31 (p. 333) for all three levels of government. It is apparent that taxes, especially at the Federal and State levels, have increased more rapidly than income. Increases in expenditures appear in table 41 (p. 358). The nature of these taxes and expenditures is shown in tables 32–40 (pp. 334 to 357). Trends in debts are presented in tables 42–45 (pp. 358 to 360).

1. FEDERAL FISCAL SYSTEM

(*a*) *Decline of customs but retention of a strong consumption tax system.*

Until the Civil War, the customs were virtually the entire Federal tax system; from the Civil War down to the World War they furnished about half of Federal revenues. Before the present war, the proportion was about 10 percent and now, of course, it is even less (three percent in 1942; see table 34, p. 339). On the other hand, during and following the Civil War, tobacco taxes and, except for the prohibition period, liquor taxes occupied a large place in the Federal revenue picture. Other excises were added from time to time. Including the tax on motor fuel and motor vehicles and the customs, these consumption taxes amounted to about 23 percent of Federal revenues in 1942 (table 34, p. 339). This percentage is much less than in any preceding year, except for the period from 1918 to 1922.

(*b*) *Prominence of business taxes.*

A conspicuous feature of the American tax system at both the Federal and State levels (as contrasted for instance with the British system) is its heavy reliance upon business taxes. At the Federal level this takes the form, for the most part, of corporation income and profits taxes (table 33, p. 337). These taxes have been relied on quite consistently for more revenue than is produced by the individual income tax, and in 1942 they account for more than one-third of all tax revenues.

[1] Most of the tables in this section were prepared mainly by Loren D. Melton. The discussion of fiscal policy is based in part on a monograph for this study: William B. Oates, Jr., Implementing a Post-War Public Investment Program. This chapter deals with over-all financial problems as well as with intergovernmental fiscal relations. The former are considered as included to some extent within the province of this study, and of course have important implications for intergovernmental fiscal relations.

(c) *Development of personal taxes; their characteristics.*

When the short-lived Federal income tax of 1894 was enacted, a tax exacted from the citizen as the latter's personal obligation to government was virtually unknown at the Federal level. Beginning with the sixteenth amendment in 1913, personal taxes have been given a considerable but not a predominant place in the tax system. In 1942, this source produced more than the consumption taxes, described above. Combining the personal income tax with the corporate income and profits taxes, the Federal income taxes produced 60 percent of Federal revenues; and adding the estate and gift taxes, which possess some of the same characteristics, the so-called ability-to-pay taxes produced nearly two-thirds of the total. These ability-to-pay taxes are regarded primarily as a desirable way of raising revenue, but they are also approved by some persons as an instrument for the redistribution of wealth and income. That the redistribution aspect may be quite prominent in the United States is suggested by the conspicuously high exemptions (especially in the estate tax) which have prevailed here (as compared, for example, with those in Great Britain).

(d) *Entrance of pay-roll taxes.*

Finally, the pay-roll tax entered the Federal tax system with the enactment of the Social Security Act in 1935. This tax was producing one-third as much as the personal income tax in 1941. Uncertain as to incidence and economic effects, and imposed without exemptions, this tax has been the subject of much criticism. Its justification lies in the fact that it is in part a benefit tax, in part a method of charging to industry labor costs that must otherwise fall on labor itself or society at large.

Charts 4 and 5 (pp. 338 and 340) show the changing importance of the different Federal taxes over the past 28 years.

(e) *Expanding Federal expenditure.*

War is, of course, responsible for the recent great increase in Federal expenditures, but during the thirties the marked increase was for welfare purposes. The welfare function was elevated in a few years from a local and in large part a private matter to a major concern of the Federal Government.

(f) *Conscious use of Government spending and debt in the attempt to maximize national income and underwrite employment opportunity.*

The most important fiscal trends of the last 10 years have not occurred in taxation, although they may have affected the latter. The principal changes have concerned the role of the Government in the control of business fluctuations. During the twenties the Government was regarded as an institution designed to provide certain services in exchange for taxes. During the thirties the view prevailed, at least in some academic circles, that the Government must to some extent compensate in its economic role for either cyclical or chronic tendencies of the private economy to become depressed, underemployed, and not fully productive.

(g) *Relative unconcern about avoiding or reducing public debt.*

During most of American history, Government debts have been regarded as essentially like individual debts—to be avoided if possible, kept to a minimum in any event, and paid off at the first available opportunity. This was the attitude that prevailed in the twenties, and the Federal debt, during this period, was very substantially reduced. During the thirties, debts became involved in the new fiscal policy. They were regarded by many as a necessary device to counteract deflation.

2. FISCAL SYSTEMS OF THE STATES AND THEIR SUBDIVISIONS

Modifications in State and local tax systems have been occurring gradually for many years, but under the extraordinary pressures of the depression of the thirties the pace was so greatly accelerated that some commentators have referred to the changes of that period as revolutionary. These developments are apparent in tables 35 to 39 and charts 6 to 11 (pp. 340 to 355).

(*a*) *Decline of the property tax.*

The property tax is no longer the principal means of State support. Many States have ceased entirely to rely on this source, and its prominence as a source of State support has declined generally. However, here, as elsewhere in the fiscal system at the State level, substantial differences exist among the States. Thus, Minnesota, in spite of a diversified tax system, still relies heavily on the property tax for State revenue, and Nebraska and Nevada, with very simple and unmodified State tax systems, rely on it even more heavily.

At the local level, the general property tax continues to be the overwhelmingly important source of locally raised revenue. (See tables 37 and 38 (pp. 349, 352) and chart 10 (p. 353)). In fact, many jurisdictions are precluded, either by law or by circumstances, from tapping other substantial sources.

(*b*) *New sources of State revenue.*

Among the principal new sources of revenue used by the States to replace the property tax are the motor-vehicle taxes. (See table 39 (p. 354) and chart 11 (p. 355).) These very productive sources have been used in all States for more than a decade. While much of the revenue from them is earmarked for highway purposes, about 15 percent is "diverted." Other taxes that have assumed an important place in State revenues are: The income tax, which has spread persistently until it is now found in about two-thirds of the States, though not always as a major producer of revenue; business taxes, under a great variety of names and formulas, including occupational taxes, capital-stock taxes, corporate-excess taxes, franchise taxes, and corporate gross-receipts and net-income taxes; special excises, particularly upon liquor and tobacco; and general excises or sales taxes, now applied in nearly half of the States, which are very substantial producers of revenue. All these taxes scored important gains during the depression of the thirties. (See tables 35 and 36 (pp. 340ff., 345ff.), and charts 8 and 9 (pp. 350, 351).)

(*c*) *Growth of governmental transfers.*

Through both shared taxes and State aids, the States have assumed a growing responsibility for local fiscal requirements. (See table 40 (pp. 356–7).) The governmental transfers have been particularly effective, in many States, in reducing local rural property taxes. In Michigan, for instance, rural property tax burdens have declined materially.[2] Cities have received relatively less State support than the rural areas and because of this fact and the development of heavy new responsibilities, particularly for welfare, city property tax rates have tended to rise rather than fall.

(*d*) *Growth of welfare expenditures.*

As previously mentioned, welfare expenditures have risen rapidly into prominence at the State and local as well as at the national level. Whereas the developing costs of highways had been the principal concern during the twenties, provision for the aged and the unemployed became the outstanding object of solicitude during the thirties. (See table 41 (p. 358).)

(*e*) *Municipalities seek new sources of revenue.*

Municipalities, as previously indicated, have been hard pressed to meet their obligations, notwithstanding some aid from the States and very substantial aid from the Federal Government. Some few of them, where permitted by law, have reached out for new independent sources of revenue including the municipal sales tax (New York), earned-income tax (Philadelphia), and local motor-vehicle taxes (Kansas City). None of these taxes is very suitable for local use, although in the case of large metropolitan cities, they have worked tolerably well and have played a most important emergency role.

(*f*) *Property tax curbs.*

Among the many innovations registering substantial gains during the thirties, miscellaneous curbs on property taxation were most prominent. Tax-limitation statutes and constitutional amendments, homestead exemptions, and further abandonment of attempts to tax personal property, particularly intangible personal property, all made inroads on the availability of the property tax as a source of local revenue. The difficulty with tax delinquency, and the resentment against high fixed charges upon the farmer, home owner, and businessman, combined with the vigorous attacks of real-estate associations, precipitated what might be termed a very general rebellion against the property tax.

(*g*) *Suspension of upward trend in indebtedness.*

States and municipalities, although operating under fairly rigid restrictions on their power to borrow, expanded their indebtedness substantially during the twenties. During the depression of the thirties, however, while the Federal debt was greatly expanding, State and local debts were contracting.

3. SUMMARY OF MAJOR TRENDS IN, AND CHARACTERISTICS OF, THE FISCAL SYSTEM AS A WHOLE

(*a*) *Growth in relative importance of the central Government.*

The Federal Government has been gaining rapidly in relative fiscal importance both as an agency for collecting taxes and as an agency for providing public services. The trend in recent years can be seen in tables 31 and 32 (pp. 333 to 336) and chart 3 (p. 334). However, the growth of Federal grants left the State and local govern-

[2] D. C. Cline, Michigan Tax Trends as Related to Agriculture, Michigan Agricultural Experiment Station, Special Bulletin No. 301, East Lansing, 1940.

ments with a larger share of expenditures than they could have maintained from their independent revenue sources.

(*b*) *Changes in relative importance of different taxes.*

Changes in the nature and importance of individual taxes have been very great. The property tax is still the only important local tax, but it has declined as a State source of revenue and, with the development of other taxes, no longer dominates the field. The combined system relies heavily on business and consumption taxes, in spite of the spread of personal income taxes. Important new sources of revenue are retail sales, gasoline, and pay-roll taxes.

(*c*) *Increase in multiple taxation, and overlapping in the field of expenditure.*

Increases in revenue requirements have led to increasing competition for revenues among the different levels of government, especially Federal and State governments. This has led to double and even triple taxation in many instances. Centralization of administration has led to overlapping in the field of expenditure. There is a tendency for the Federal or State governments to undertake new activities without asking the lower levels of governments to withdraw.

(*d*) *Growth in importance of the governmental financial system in the national economy.*

The magnitude of government revenues and expenditures is sufficient, in itself, to insure that the government fiscal system will play an increasing role in the whole national economy. The increase in debts, and the emphasis on fiscal policy as a factor in controlling business fluctuations, are further reasons for expecting government finances to play a major part in the economic system.

TABLE 31.—*Tax collections and the national income in the United States for selected years, 1915–41*

Year [1]	National income	Tax collections [2]											
		Amount				Percentage distribution				Collections as percentages of national income			
		Total	Federal [3]	State [4]	Local	Total	Federal	State	Local	Total	Federal	State	Local
	Bills.	*Mills.*	*Mills.*	*Mills.*	*Mills.*								
1915	.....	$2,311	$625	$368	$1,318	100	27.1	15.9	57.0	.....	.....	.....	.....
1919	$64.2	7,023	4,034	594	2,395	100	57.4	8.5	34.1	10.9	6.3	0.9	3.7
1922	60.7	7,657	3,553	947	3,157	100	46.4	12.4	41.2	12.6	5.9	1.6	5.2
1925	76.0	8,082	2,966	1,305	3,811	100	36.7	16.1	47.2	10.6	3.9	1.7	5.0
1928	80.0	9,591	3,194	1,756	4,641	100	33.3	18.3	48.4	12.0	4.0	2.2	5.8
1930	68.8	10,594	3,468	2,108	5,018	100	32.7	19.9	47.4	15.4	5.0	3.1	7.3
1931	54.4	9,564	2,717	2,042	4,805	100	28.4	21.4	50.2	17.6	5.0	3.8	8.8
1932	39.9	8,307	1,788	1,862	4,657	100	21.5	22.4	56.1	20.8	4.5	4.7	11.7
1933	42.3	7,719	1,785	1,724	4,210	100	23.1	22.3	54.6	18.2	4.2	4.1	10.0
1934	49.3	9,029	2,890	1,979	4,160	100	32.0	21.9	46.1	18.3	5.9	4.0	8.4
1935	55.7	10,061	3,545	2,217	4,299	100	35.2	22.1	42.7	18.1	6.4	4.0	7.7
1936	61.9	10,776	3,845	2,641	4,290	100	35.7	24.5	39.8	16.6	5.9	4.1	6.6
1937	71.5	12,834	5,028	3,436	4,370	100	39.2	26.8	34.0	17.9	7.0	4.8	6.1
1938	64.1	14,125	5,934	3,847	4,344	100	42.0	27.2	30.8	22.0	9.3	6.0	6.8
1939	70.8	13,620	5,412	3,908	4,300	100	39.7	28.7	31.6	19.2	7.6	5.5	6.1
1940	77.2	14,118	5,566	4,187	4,365	100	39.4	29.7	30.9	18.3	7.2	5.4	5.7
1941	94.5	17,884	7,671	4,961	5,252	100	42.9	27.7	29.4	18.9	8.1	5.2	5.6

[1] National income for calendar years; tax collections for fiscal years.
[2] Including pay-roll taxes.
[3] Less refunds.
[4] Including local shares.

Sources: National income: 1919–28, S. Kuznets, National Income and Its Composition, 1919–38, National Bureau of Economic Research, 1941; 1939–41, data from Department of Commerce. Federal tax collections: Treasury Department, Annual Reports of the Secretary. State tax collections: 1915–40, Total State taxes, table 35 plus Unemployment compensation taxes, table 35; 1941, Bureau of the Census, Financing Federal, State and Local Governments: 1941, p. 22. Local tax collections: 1915–40, Total local tax collections, table 37; 1941, Bureau of the Census, Financing Federal, State, and Local Governments: 1941, p. 22.

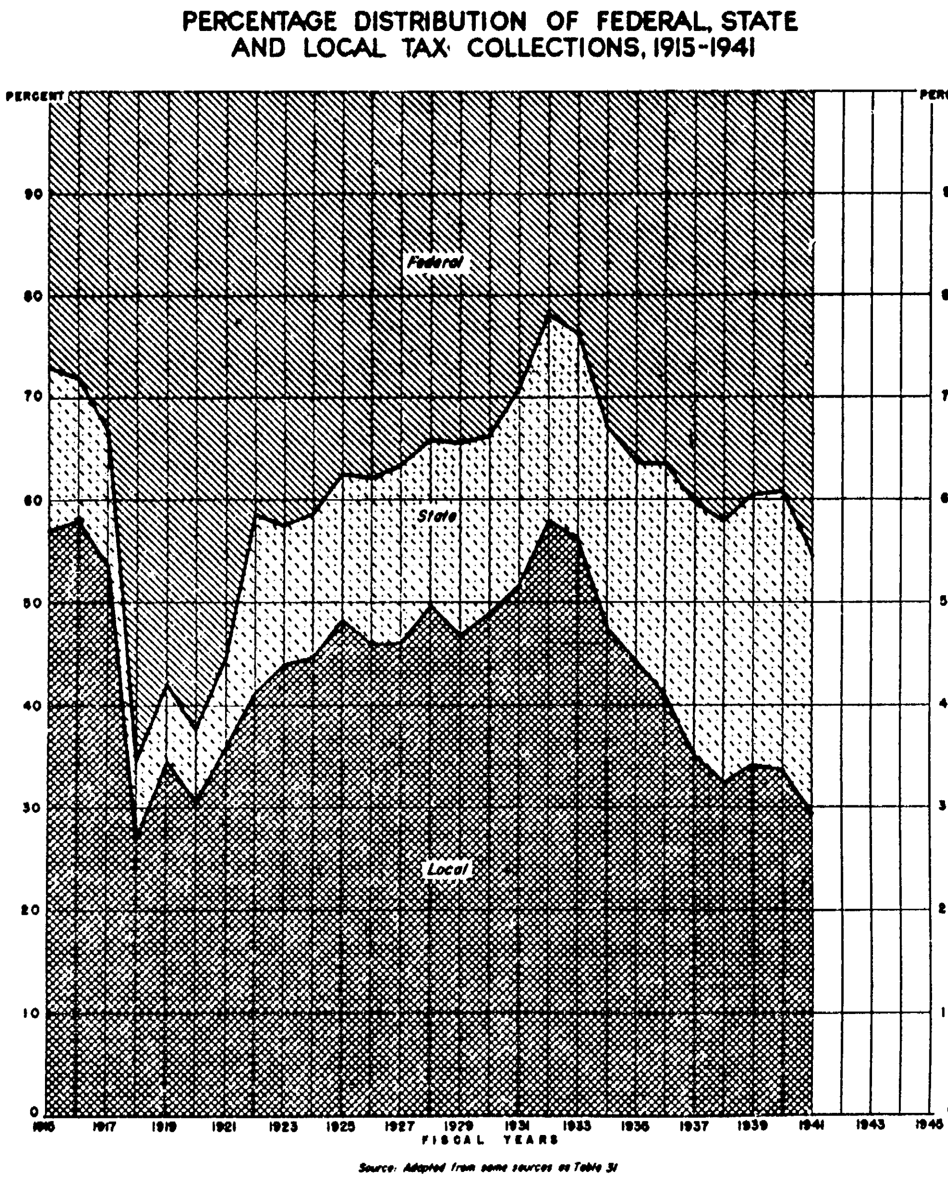


CHART 3.

TABLE 32.—*Federal and estimated State and local tax revenues, 1941*

Tax	Amount of tax revenue			
	Total	Federal	State	Local
	Millions	*Millions*	*Millions*	*Millions*
Net income taxes	$3,916	$3,471	$423	[1] $22
Individual	1,671	1,418	233	20
Corporate	2,245	2,053	190	2
Death and gift taxes	529	407	121	1
Property taxes [2]	4,473		250	4,224
Taxes on specific businesses	890	193	519	179
Corporations and public utilities [3]	440	170	220	40
Alcoholic beverages	105	12	58	35
Insurance	104		104	
Severance and other [4]	242	1	137	104

See footnotes at end of table.

TABLE 32.—*Federal and estimated State and local tax revenues, 1941*—Continued

Tax	Amount of tax revenue			
	Total	Federal	State	Local
	Millions	*Millions*	*Millions*	*Millions*
Sales and gross income taxes	$4,244	$2,335	$1,822	$88
General sales	632		566	[5] 66
Alcoholic beverages	1,023	808	216	
Tobacco	805	698	107	
Miscellaneous excises	362	330	[6] 19	[7] 14
Motor-vehicle fuel	1,421	[8] 499	914	7
Motor-vehicle licenses	441	(9)	417	24
Pay-roll taxes	1,900	[10] 993	901	5
Other taxes	138	28	46	64
Licenses offsetting services	86	2	34	[11] 50
Poll and miscellaneous	51	25	12	14
Customs	392	392		
Total taxes	16,923	7,818	4,499	4,606

Tax	Percentage distribution			
	Total	Federal	State	Local
Net income taxes	100	88.6	10.8	0.6
Individual	100	84.8	14.0	1.2
Corporate	100	91.5	8.4	.1
Death and gift taxes	100	77.0	22.9	.1
Property taxes [2]	100		5.6	94.4
Taxes on specific businesses	100	21.6	58.3	20.1
Corporations and public utilities [3]	100	40.8	50.1	9.1
Alcoholic beverages	100	11.3	55.1	33.6
Insurance	100		100.0	
Severance and other [4]	100	.5	56.6	42.9
Sales and gross income taxes	100	55.0	42.9	2.1
General sales	100		89.5	10.5
Alcoholic beverages	100	78.9	21.1	
Tobacco	100	86.7	13.3	(12)
Miscellaneous excises	100	91.0	5.1	3.8
Motor-vehicle fuel	100	35.1	64.4	.5
Motor-vehicle licenses	100	(12)	94.6	5.4
Pay-roll taxes	100	52.3	47.4	.3
Other taxes	100	20.2	33.5	46.3
Licenses offsetting services	100	2.8	39.3	57.9
Poll and miscellaneous	100	49.5	23.8	26.7
Customs	100	100.0		
Total taxes	100	100.0	100.0	100.0

See footnotes at end of table.

TABLE 32.—*Federal and estimated State and local tax revenues, 1941*—Continued

Tax	Percent of total		
	Federal	State	Local
Net income taxes	44.4	9.4	0.5
Individual	18.1	5.2	.4
Corporate	26.3	4.2	(9)
Death and gift taxes	5.2	2.7	(12)
Property taxes [2]	....	5.6	91.7
Taxes on specific businesses	2.5	11.5	3.9
Corporations and public utilities [3]	2.3	4.9	.9
Alcoholic beverages	.2	1.3	.8
Insurance	....	2.3	....
Severance and other [4]	(9)	3.0	2.3
Sales and gross income taxes	29.9	40.5	1.9
General sales	....	12.6	1.4
Alcoholic beverages	10.3	4.8	....
Tobacco	8.9	2.4	....
Miscellaneous excises	4.2	.4	.3
Motor-vehicle fuel	6.4	20.3	.2
Motor-vehicle licenses	(12)	9.3	.5
Pay-roll taxes	12.7	20.0	.1
Other taxes	.4	1.0	1.4
Licenses offsetting services	(9)	.8	1.1
Poll and miscellaneous	.3	.3	.3
Customs	5.0	....	....
Total taxes	100.0	100.0	100.0

[1] Includes Philadelphia individually earned income taxes of $18,377,901, and District of Columbia net income taxes of $3,872,000.

[2] Comprises general and selective property taxes. Special property taxes are reported under taxes on specific businesses.

[3] Includes Federal stock-transfer taxes of $12,176,497, Federal capital-stock tax of $166,652,640, and State stock-transfer and documentary taxes of $23,384,000.

[4] Includes chain store, tonnage, amusement, and betting taxes, and business licenses for revenue.

[5] Consists of yield of sales taxes of New York City, New Orleans, cities in West Virginia, and licenses measured by gross sales.

[6] Includes taxes on admissions and the sale of soft drinks.

[7] Consists chiefly of the yield from the New York City taxes on business gross income.

[8] Includes Federal taxes on motor vehicles and accessories.

[9] Less than $500,000.

[10] Includes $61,347,000 of contributions to the railroad unemployment trust fund.

[11] Includes regulatory and nonbusiness licenses and charges for street and highway use.

[12] Less than ½ of 1 percent.

Source: Adapted from Bureau of the Census, Financing Federal, State, and Local Governments: 1941.

TABLE 33.—*Federal tax revenues, 1915–42*

(See table 34 for percentage distribution)

[In millions]

Tax	1915	1916	1917	1918	1919	1920	1921	1922	1923
Individual income	$41	$68	$180	$2,852	$2,601	$3,957	$3,228	$2,087	$1,691
Corporate income [1]	39	57	207						
Estate and gift			6	47	82	104	154	139	127
Capital stock			10	25	29	93	82	81	82
Alcoholic beverages	235	247	284	444	483	140	83	46	30
Tobacco	80	88	103	156	206	296	255	271	309
Motor fuel									
Other manufacturers' excises	2	4	1	37	79	268	229	174	185
Stock transfer [2]				2	8	13	9	9	10
Customs [3]	210	213	226	180	184	323	309	356	562
Pay roll [4]									
Other [5]	18	49	18	136	362	537	555	390	188
Total taxes	625	726	1,035	3,879	4,034	5,731	4,904	3,553	3,184

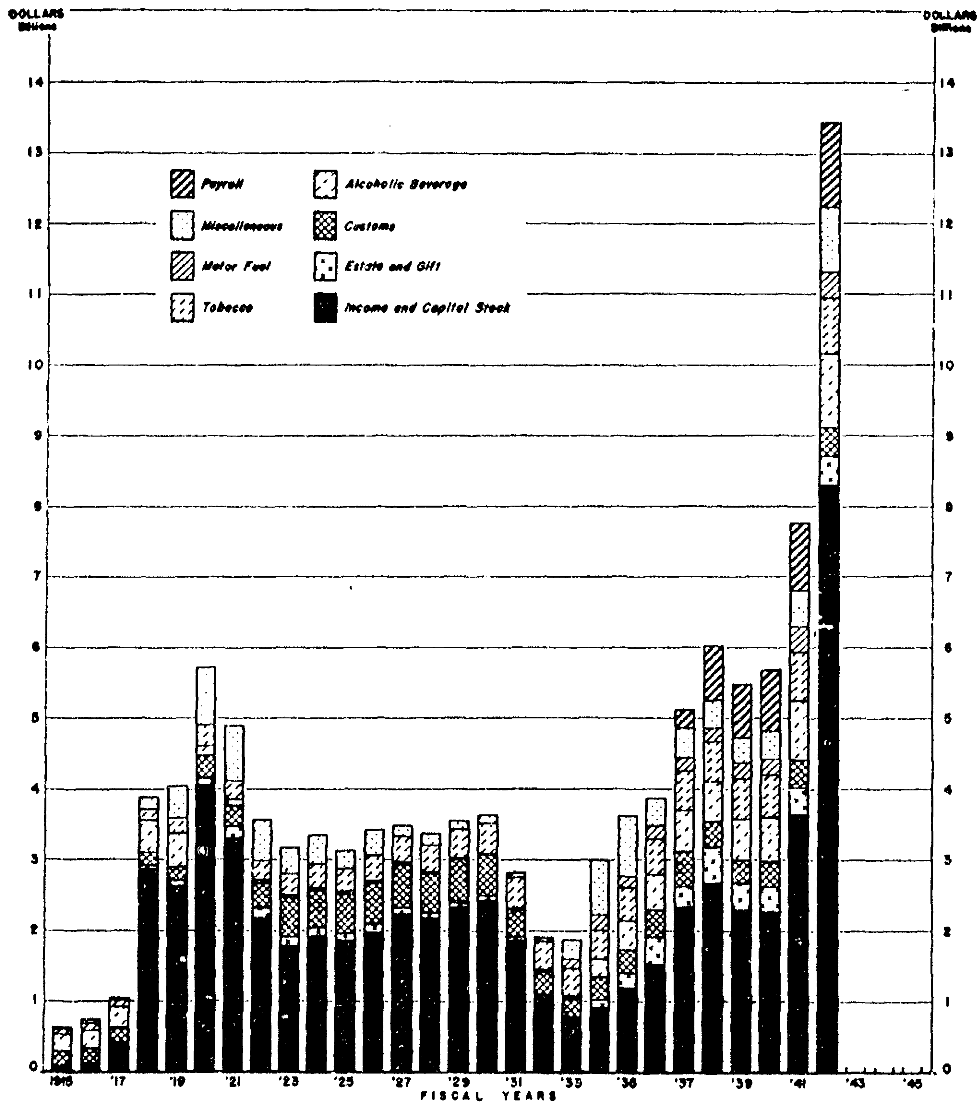
Tax	1924	1925	1926	1927	1928	1929	1930	1931	1932
Individual income	$1,842	$846	$879	$912	$883	$1,095	$1,147	$834	$427
Corporate income [1]		916	1,095	1,308	1,292	1,236	1,263	1,026	630
Estate and gift	103	109	119	100	60	62	65	48	47
Capital stock	87	90	97	9	9	6			
Alcoholic beverages	28	26	26	21	15	13	12	10	9
Tobacco	326	345	371	376	396	434	450	444	399
Motor fuel									
Other manufacturers' excises	201	141	150	67	52	6	3		
Stock transfer [2]	8	13	17	17	24	38	47	26	18
Customs [3]	546	548	579	605	569	602	587	378	328
Pay roll [4]									
Other [5]	201	98	82	56	59	49	53	40	28
Total taxes	3,342	3,132	3,415	3,471	3,359	3,541	3,627	2,806	1,886

Tax	1933	1934	1935	1936	1937	1938	1939	1940	1941	1942
Individual income	$353	$120	$527	$674	$1,092	$1,286	$1,029	$982	$1,418	$3,263
Corporate income [1]	394	400	579	753	1,088	1,343	1,156	1,148	2,053	4,745
Estate and gift	34	113	212	379	306	417	361	360	407	433
Capital stock		80	92	95	137	139	127	133	167	282
Alcoholic beverages	43	259	411	505	594	568	588	624	820	1,018
Tobacco	403	425	459	501	552	568	580	608	698	781
Motor fuel	125	203	162	177	197	204	207	226	343	370
Other manufacturers' excises	119	182	180	206	254	213	190	221	274	482
Stock transfer [2]	33	38	16	33	31	18	17	16	12	13
Customs [3]	251	313	343	387	486	359	319	349	392	389
Pay roll [4]					253	743	740	838	932	1,185
Other [5]	116	552	661	171	130	145	167	152	244	428
Total taxes	1,871	2,985	3,642	3,881	5,120	6,003	5,481	5,657	7,760	13,419

[1] Includes excess-profits taxes.
[2] Included in "Other," 1915–17.
[3] Tonnage tax included in "Customs," 1915–31.
[4] Includes deposits by Railroad Retirement Board of $14,000,000 in 1940 and $61,000,000 in 1941.
[5] Includes processing taxes (under the Agricultural Adjustment program) of $371,000,000, 1934; $526,000,000, 1935; and $62,000,000, 1936.

Source: Compiled from Treasury Department, Annual Reports of the Secretary.

FEDERAL TAX REVENUES BY SOURCES, 1915-1942



Source: Table 33

CHART 4.

TABLE 34.—*Federal tax revenues, 1915–42*

[Percentage distribution of data presented in table 33]

Tax	1915	1916	1917	1918	1919	1920	1921	1922	1923
Individual income	6.6	9.4	17.4	73.5	64.5	69.1	65.8	58.7	53.1
Corporate income [1]	6.2	7.9	20.0						
Estate and gift			.6	1.2	2.0	1.8	3.1	3.9	4.0
Capital stock			1.0	.6	.7	1.6	1.7	2.3	2.6
Alcoholic beverages	37.6	34.0	27.4	11.5	12.0	2.4	1.7	1.3	.9
Tobacco	12.8	12.1	10.0	4.0	5.1	5.2	5.2	7.6	9.7
Motor fuel									
Other manufacturers' excises	.3	.6	.1	1.0	1.9	4.7	4.7	4.9	5.8
Stock transfer [2]				.1	.2	.2	.2	.3	.3
Customs [3]	33.6	29.3	21.8	4.6	4.6	5.6	6.3	10.0	17.7
Pay roll [4]									
Other [5]	2.9	6.7	1.7	3.5	9.0	9.4	11.3	11.0	5.9
Total taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Tax	1924	1925	1926	1927	1928	1929	1930	1931	1932
Individual income	55.1	27.0	25.7	26.3	26.3	30.9	31.6	29.7	22.6
Corporate income [1]		29.3	32.1	37.7	38.5	34.9	34.8	36.6	33.4
Estate and gift	3.1	3.5	3.5	2.9	1.8	1.7	1.8	1.7	2.5
Capital stock	2.6	2.9	2.8	.3	.3	.2			
Alcoholic beverages	.8	.8	.8	.6	.4	.4	.3	.4	.5
Tobacco	9.8	11.0	10.9	10.8	11.8	12.2	12.4	15.8	21.2
Motor fuel									
Other manufacturers' excises	6.0	4.5	4.4	1.9	1.5	1.2	.1		
Stock transfer [2]	.3	.4	.5	.5	.7	1.1	1.3	.9	.9
Customs [3]	16.3	17.5	16.9	17.4	16.9	17.0	16.2	13.5	17.4
Pay roll [4]									
Other [5]	6.0	3.1	2.4	1.6	1.8	1.4	1.5	1.4	1.5
Total taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Tax	1933	1934	1935	1936	1937	1938	1939	1940	1941	1942
Individual income	18.9	14.0	14.5	17.4	21.3	21.4	18.8	17.4	18.3	24.3
Corporate income [1]	21.0	13.4	15.9	19.4	21.3	22.4	21.1	20.3	26.5	35.4
Estate and gift	1.8	3.8	5.8	9.8	6.0	6.9	6.6	6.4	5.2	3.2
Capital stock		2.7	2.5	2.4	2.7	2.3	2.3	2.3	2.2	2.1
Alcoholic beverages	2.3	8.7	11.3	13.0	11.6	9.5	10.7	11.0	10.6	7.8
Tobacco	21.5	14.2	12.6	12.9	10.8	9.5	10.6	10.7	9.0	5.8
Motor fuel	6.7	6.8	4.5	4.6	3.8	3.4	3.8	4.0	4.4	2.8
Other manufacturers' excises	6.4	6.1	4.9	5.3	5.0	3.5	3.5	3.9	3.5	3.6
Stock transfer [2]	1.8	1.3	.4	.8	.6	.3	.3	.3	.2	.1
Customs [3]	13.4	10.5	9.4	10.0	9.5	6.0	5.8	6.2	5.0	2.9
Pay roll [4]					4.9	12.4	13.5	14.8	12.0	8.8
Other [5]	6.2	18.5	18.2	4.4	2.5	2.4	3.0	2.7	3.1	3.2
Total taxes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

[1] Includes excess-profits taxes.
[2] Included in "Other," 1915–17.
[3] Tonnage tax included in "Customs," 1915–31.
[4] Includes deposits by Railroad Retirement Board of $14,000,000 in 1940 and $61,000,000 in 1941.
[5] Includes processing taxes (under the Agricultural Adjustment program) of $371,000,000, 1934; $526,000,000, 1935; and $62,000,000, 1936.

Source: Computed from data compiled from Treasury Department, Annual Reports of the Secretary.

PERCENTAGE DISTRIBUTION OF
FEDERAL TAX REVENUES BY SOURCES, 1915-1942

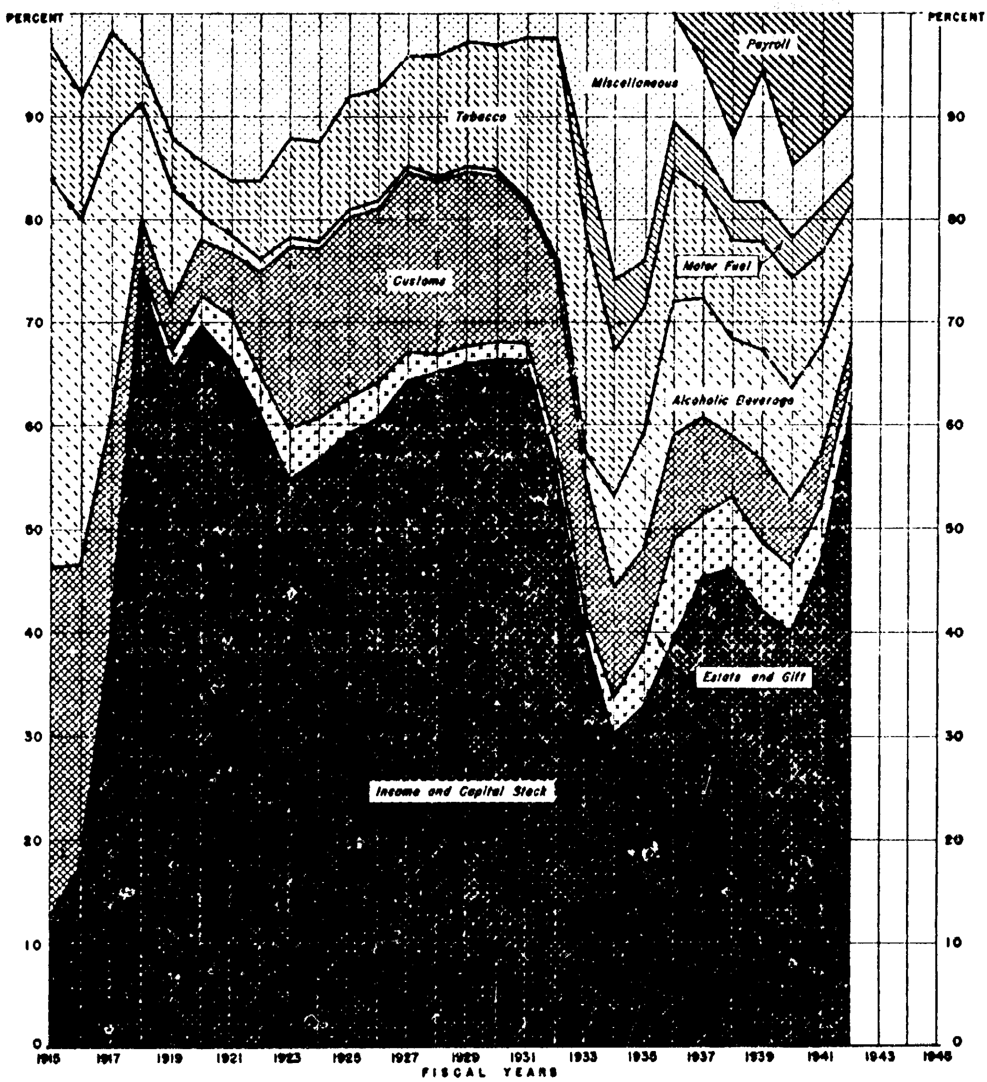


CHART 5.

TABLE 35.—*Trends in State tax collections, 1915–40* [1]

(For percentage distribution, see table 36)

[In millions]

Tax	1915	1919	1922	1923	1924
Total State taxes [2]	$367.9	$594.0	$947.3	$1,019.5	$1,138.7
1. General and selective property taxes	[3] 185.9	[3] 237.2	[3] 348.3	[3] 352.5	[3] 351.6
2. Severance taxes					
3. Motor-vehicle taxes [4]	[4] 14.9	[4] 64.7	[4] 152.0	[4] 189.0	[4] 225.5
4. Sales taxes		1.0	12.7	38.6	80.4
(a) General sales					
(b) Motor fuel		[5] 1.0	[5] 12.7	[5] 38.6	[5] 80.4
(c) Alcoholic beverage					
(d) Tobacco products [6]					
(e) Admissions and amusements [7]					
(f) Soft drinks					
(g) Oleomargarine					

See footnotes at end of table.

TABLE 35.—*Trends in State tax collections, 1915–40*—Continued

Tax	1915	1919	1922	1923	1924
5. Taxes on specific businesses	$132.8	$180.1	$242.6	$236.1	$272.9
(a) Public utilities					
(b) Insurance					
(c) Chain stores					
(d) Betting or racing					
(e) Corporation (franchise)					
(f) Alcoholic beverage licenses [8]	[3] 20.8	[3] 14.2			
(g) Other business licenses [9]	[3] 78.7	[3] 121.7	[3] 161.6	[3] 152.5	[3] 178.5
(h) Special property [10]	[3] 33.3	[3] 41.2	[3] 81.0	[3] 83.6	[3] 94.4
6. Net income taxes [11]	[3] 2.3	[3] 49.5	[12] 97.6	[13] 92.7	[12] 101.1
(a) Individual					
(b) Corporation					
(c) Not allocable					
7. Death and gift taxes	[3] 28.8	[3] 45.8	[3] 63.1	[3] 74.9	[3] 79.3
8. Poll taxes	[3] 3.2	[3] 2.1	[3] 8.3	[3] 6.7	[3] 3.6
9. Miscellaneous licenses [14]					
10. Documentary and stock registration					
11. All other taxes [15]		[3] 13.6	[3] 19.7	[3] 29.0	[3] 24.3
12. Unemployment compensation					

Tax	1925	1926	1927	1928
Total State taxes [2]	$1,305.3	$1,464.7	$1,607.5	$1,756.1
1. General and selective property taxes	[3] 358.6	[3] 375.7	[3] 370.4	[3] 381.2
2. Severance taxes				
3. Motor-vehicle taxes [4]	[5] 260.6	[5] 288.3	[5] 301.1	[5] 322.6
4. Sales taxes	148.4	187.6	258.8	304.9
(a) General sales				
(b) Motor fuel	[5] 148.4	[5] 187.6	[5] 258.8	[5] 304.9
(c) Alcoholic beverage				
(d) Tobacco products [6]				
(e) Admissions and amusements [7]				
(f) Soft drinks				
(g) Oleomargarine				
5. Taxes on specific businesses	304.0	330.9	353.2	369.2
(a) Public utilities				
(b) Insurance				
(c) Chain stores				
(d) Betting or racing				
(e) Corporation (franchise)				
(f) Alcoholic beverage licenses [8]				
(g) Other business licenses [9]	[3] 213.8	[3] 235.6	[3] 253.7	[3] 263.6
(h) Special property [10]	[3] 90.2	[3] 95.3	[3] 99.5	[3] 105.6
6. Net income taxes [11]	[3] 102.8	[12] 134.1	[12] 162.2	[12] 184.0
(a) Individual				
(b) Corporation				
(c) Not allocable				
7. Death and gift taxes	[3] 85.9	[3] 90.6	[3] 105.9	[3] 127.5
8. Poll taxes	[3] 3.9	[3] 3.7	[3] 3.4	[3] 3.9
9. Miscellaneous licenses [14]	[3] 8.8	[3] 10.0	[3] 11.3	[3] 12.9
10. Documentary and stock registration				
11. All other taxes [15]	[3] 32.3	[3] 43.8	[3] 41.2	[3] 49.9
12. Unemployment compensation				

See footnotes at end of table.

TABLE 35.—*Trends in State tax collections, 1915–40*—Continued

Tax	1929	1930	1931	1932
Total State taxes [2]	$1,950.8	$2,107.5	$2,041.7	$1,861.5
1. General and selective property taxes	[3] 350.2	[3] 345.2	[3] 371.4	[16] 335.2
2. Severance taxes			[16] 26.5	[16] 19.3
3. Motor-vehicle taxes [4]	[5] 347.8	[5] 355.7	[5] 344.3	[5] 321.3
4. Sales taxes	431.3	508.2	562.6	543.0
(a) General sales		[3] 1.2	[16] 7.7	[16] 7.1
(b) Motor fuel	[5] 431.3	[5] 494.7	[5] 530.4	[5] 513.0
(c) Alcoholic beverage			[16] .9	[15] 1.4
(d) Tobacco products [6]		[13] 12.3	[13] 14.6	[13] 18.9
(e) Admissions and amusements [7]			[16] 1.5	[16] 1.4
(f) Soft drinks			[16] 1.0	[16] .7
(g) Oleomargarine			[16] .5	[16] .5
5. Taxes on specific businesses	381.8	392.9	300.5	297.8
(a) Public utilities			[16] 110.5	[16] 105.3
(b) Insurance			[16] 72.4	[16] 75.3
(c) Chain stores			[16] .1	[16] 1.3
(d) Betting or racing			[16] 1.5	[16] 2.3
(e) Corporation (franchise)			[16] 105.9	[16] 103.0
(f) Alcoholic beverage licenses [8]				
(g) Other business licenses [9]	[3] 272.9	[3] 296.4	[16] 10.1	[16] 10.6
(h) Special property [10]	[3] 108.9	[3] 96.5		
6. Net income taxes [11]	[17] 203.9	[3] 233.4	200.5	152.4
(a) Individual			[16] 86.0	[16] 73.6
(b) Corporation			[16] 114.5	[16] 78.8
(c) Not allocable				
7. Death and gift taxes	[3] 148.6	[13] 183.4	[16] 187.1	[16] 147.9
8. Poll taxes	[3] 3.5	[3] 4.1	[3] 5.1	[16] 3.4
9. Miscellaneous licenses [14]	[3] 11.5	[3] 14.5	[18] 14.0	[18] 13.5
10. Documentary and stock registration			[16] 28.4	[16] 22.8
11. All other taxes [15]	[3] 69.2	[3] 70.1	[16] 1.3	[15] 1.9
12. Unemployment compensation				

Tax	1933	1934	1935	1936
Total State taxes [2]	$1,724.4	$1,979.4	$2,216.9	$2,618.2
1. General and selective property taxes	[16] 285.1	[16] 273.3	[16] 248.1	[16] 227.5
2. Severance taxes	[16] 14.0	[16] 20.6	[16] 26.1	[16] 34.1
3. Motor vehicle taxes [4]	[5] 302.7	[5] 304.9	[5] 322.8	[5] 359.8
4. Sales taxes	562.3	830.7	1,050.3	1,231.5
(a) General sales	[16] 16.1	[3] 173.4	[3] 284.4	[3] 364.0
(b) Motor fuel	[5] 518.2	[5] 565.0	[5] 616.9	[5] 686.6
(c) Alcoholic beverage	[13] 6.1	[13] 64.2	[13] 114.2	[16] 120.4
(d) Tobacco products [6]	[13] 20.1	[13] 24.6	[13] 28.7	[16] 43.5
(e) Admissions and amusements [7]	[16] 1.1	[16] 2.2	[16] 4.5	[16] 6.1
(f) Soft drinks	[16] .4	[16] 1.0	[16] 1.2	[16] 1.2
(g) Oleomargarine	[15] .3	[15] .3	[16] .4	[16] .7
5. Taxes on specific businesses	260.2	270.9	268.6	315.7
(a) Public utilities	[16] 96.8	[16] 94.0	[16] 69.0	[16] 77.2
(b) Insurance	[16] 66.6	[16] 66.8	[16] 68.9	[16] 72.8
(c) Chain stores	[16] .6	[16] 2.0	[16] 3.0	[16] 4.5
(d) Betting or racing	[16] 2.4	[16] 4.2	[16] 8.9	[16] 9.3
(e) Corporation (franchise)	[16] 81.0	[16] 77.7	[16] 79.3	[16] 104.0
(f) Alcoholic beverage licenses [8]	[13] 3.7	[13] 17.2	[17] 28.3	[16] 37.0
(g) Other business licenses [9]	[16] 9.1	[16] 9.0	[16] 9.2	[16] 10.9
(h) Special property [10]				
6. Net income taxes [11]	120.7	129.0	159.3	265.3
(a) Individual	[16] 63.5	[15] 79.9	[16] 105.0	[16] 152.5
(b) Corporation	[16] 57.2	[16] 49.1	[16] 54.3	[16] 112.8
(c) Not allocable				
7. Death and gift taxes	[16] 126.5	[16] 93.4	[16] 100.0	[15] 117.0
8. Poll taxes	[16] 2.6	[16] 3.7	[16] 5.8	[16] 8.2
9. Miscellaneous licenses [14]	[18] 14.0	[18] 14.6	[18] 15.5	[18] 16.2
10. Documentary and stock registration	[16] 35.0	[16] 36.6	[16] 19.2	[16] 40.1
11. All other taxes [15]	[16] 1.3	[16] 1.8	[16] 3.2	[16] 2.8
12. Unemployment compensation				[4] 23.2

See footnotes at end of table.

TABLE 35.—*Trends in State tax collections, 1915–40*—Continued

Tax	1937	1938	1939	1940 [19]
Total State taxes [2]	$3,088.8	$3,146.8	$3,108.8	$3,342.9
1. General and selective property taxes	[3] 291.9	[3] 244.0	[3] 259.2	[3] 264.7
2. Severance taxes	[16] 48.9	[16] 62.5	[16] 49.3	[16] 52.8
3. Motor vehicle taxes [4]	[5] 399.6	[5] 388.8	[16] 386.3	[16] 411.8
4. Sales taxes	1,434.7	1,454.4	1,483.4	1,642.7
(a) General sales	[3] 434.4	[3] 446.8	[3] 440.1	[3] 490.2
(b) Motor fuel	[5] 756.9	[5] 766.9	[5] 800.9	[5] 845.4
(c) Alcoholic beverage	[3] 177.0	[3] 174.7	[3] 174.3	[3] 200.0
(d) Tobacco products [6]	[16] 52.9	[16] 56.1	[16] 59.5	[16] 97.8
(e) Admissions and amusements [7]	[16] 8.7	[16] 6.2	[16] 5.0	[16] 5.5
(f) Soft drinks	[16] 4.0	[16] 2.9	[16] 3.0	[16] 3.3
(g) Oleomargarine	[16] .8	[16] .8	[16] .6	[16] .5
5. Taxes on specific businesses	363.0	393.1	396.5	428.3
(a) Public utilities	[16] 89.3	[16] 116.9	[3] 112.2	[3] 122.1
(b) Insurance	[3] 78.7	[16] 85.5	[3] 96.2	[3] 103.3
(c) Chain stores	[3] 4.7	[3] 7.2	[3] 6.2	[3] 6.8
(d) Betting or racing	[16] 11.1	[16] 11.0	[16] 11.7	[16] 14.6
(e) Corporation (franchise)	[16] 122.8	[16] 106.8	[16] 102.8	[16] 108.5
(f) Alcoholic beverage licenses [8]	[3] 44.2	[3] 51.6	[3] 53.5	[3] 59.6
(g) Other business licenses [9]	[16] 12.2	[16] 14.1	[16] 13.9	[16] 13.4
(h) Special property [10]	----------	----------	----------	----------
6. Net income taxes [11]	367.4	402.3	345.0	370.7
(a) Individual	[16] 193.3	[20] 218.5	[20] 182.5	[20] 188.1
(b) Corporation	[16] 146.1	[20] 172.0	[20] 132.6	[20] 144.3
(c) Not allocable	[16] 28.0	[20] 11.8	[20] 29.9	[20] 38.3
7. Death and gift taxes	[16] 116.1	[16] 145.4	[16] 135.2	[16] 116.4
8. Poll taxes	[16] 6.2	[16] 7.0	[16] 6.5	[16] 6.8
9. Miscellaneous licenses [14]	[3] 16.8	[3] 18.5	[3] 18.6	[3] 21.0
10. Documentary and stock registration	[16] 41.1	[16] 27.0	[16] 25.6	[16] 25.1
11. All other taxes [15]	[16] 3.1	[16] 2.8	[16] 3.2	[16] 2.6
12. Unemployment compensation	[3] 346.8	[3] 701.6	[3] 799.0	[3] 843.6

[1] Data shown represent total State tax collections including local shares. Census data for the years 1915–30, which exclude local shares, have been supplemented with data from (5) as to motor fuel and motor vehicle taxes; and from (12) and (13) in the case of income taxes. It is believed the data shown, with the substitutions indicated, represent approximate total State tax collections.

[2] Excluding unemployment compensation taxes, which are shown separately as item 12.

[3] Bureau of the Census data: Financial Statistics of States series, or Special Study No. 10, State Tax Collections: 1940.

[4] Motor vehicle taxes include fees and licenses, mileage and other taxes on motor carriers and commercial vehicles, and drivers' licenses.

[5] Tax Research Foundation, Tax Systems, 8th ed., 1940.

[6] Taxes on tobacco products include license and permit fees in minor amounts as follows (in millions): 1930, $1.8; 1931, $2.0; 1932, $1.3; 1933, $1.2; 1934, $1.6; 1935, $1.8; no data since 1935.

[7] Includes admissions taxes separately taxed from general sales, and amusements licenses, minor in amount included in "Other business licenses" prior to 1931.

[8] In several States alcoholic beverage license fees are not segregated from excise taxes; amounts shown therefore understate somewhat taxes on this specific business.

[9] "Other business licenses" for 1919, 1922, 1923, and 1924 have been arbitrarily reduced by amount of motor fuel taxes shown for those years to avoid duplication. Alcoholic beverage licenses for 1915 and 1919 also deducted from this source. This source, from 1915 to 1930, refers to business licenses as classified in Financial Statistics of States series published by the Census Bureau. Subsequent to 1930, the reference is to licenses as classified in Tax Yields: 1940, by the Tax Institute, consisting chiefly of privilege taxes common to the Southern States.

[10] "Special property" taxes, 1915–30, separately classified from general property tax; subsequent to 1930, distributed by specific businesses.

[11] Includes bank and other franchise taxes measured by net income.

[12] National Industrial Conference Board, State Income Taxes, vol. II, 1930.

[13] Treasury Department, Division of Research and Statistics, Collections from Selected State Imposed Taxes, 1930–36.

[14] "Miscellaneous licenses," 1925–30, refers to nonbusiness licenses, excluding motor vehicle licenses, and consists almost entirely of hunting and fishing licenses; collections, 1931–36, estimated. Included in motor vehicle licenses, 1915–24.

[15] "All other taxes," 1919–30, includes all special taxes other than property, death, and income taxes as reported in Financial Statistics of States; subsequent to 1930, includes miscellaneous taxes reported in Tax Yields: 1940.

[16] Tax Institute, Tax Yields: 1940.

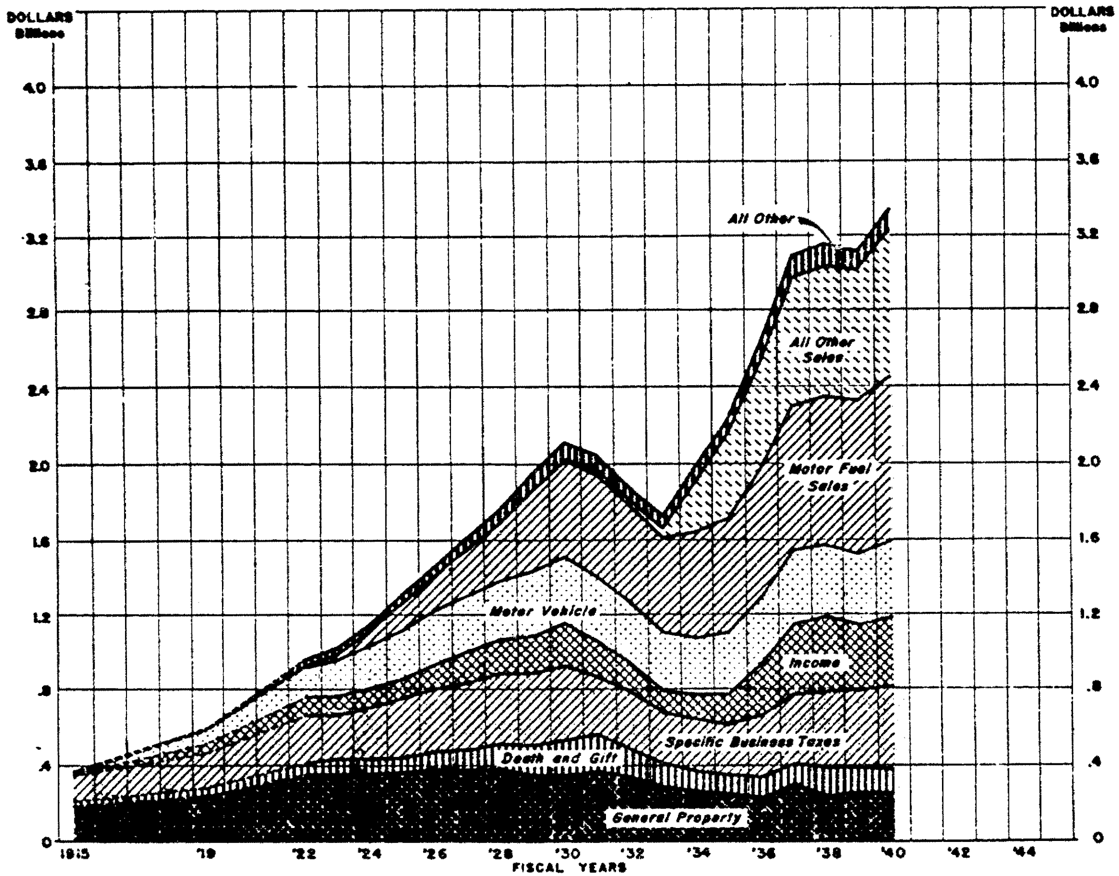
[17] Treasury Department, Division of Tax Research.

[18] Estimates prepared by staff of the Committee on Intergovernmental Fiscal Relations.

[19] Figures shown are preliminary. For revised figures, see Table 28.

[20] Income tax data for 1938–40 adapted from Financial Statistics of States.

STATE TAX REVENUES BY SOURCES 1915-1940*



Source: Table 35
*Exclusive of unemployment compensation taxes and inclusive of local shares.

CHART 6.

TABLE 36.—*Trends in State tax collections, 1915–40*

[Percentage distribution of data presented in table 35]

Tax	1915	1919	1922	1923	1924
	Percent	*Percent*	*Percent*	*Percent*	*Percent*
Total State taxes	100.0	100.0	100.0	100.0	100.0
1. General and selective property taxes	50.5	39.9	36.8	34.6	30.9
2. Severance taxes	....	....	....	....	....
3. Motor-vehicle taxes	4.1	10.9	16.0	18.5	19.8
4. Sales taxes	....	.2	1.3	3.8	7.1
(a) General sales	....	....	....	....	....
(b) Motor fuel	....	.2	1.3	3.8	7.1
(c) Alcoholic beverage	....	....	....	....	....
(d) Tobacco products	....	....	....	....	....
(e) Admissions and amusements	....	....	....	....	....
(f) Soft drinks	....	....	....	....	....
(g) Oleomargarine	....	....	....	....	....
5. Taxes on specific businesses	36.1	30.3	25.6	23.2	24.0
(a) Public utilities	....	....	....	....	....
(b) Insurance	....	....	....	....	....
(c) Chain stores	....	....	....	....	....
(d) Betting or racing	....	....	....	....	....
(e) Corporation (franchise)	....	....	....	....	....
(f) Alcoholic beverage licenses	5.7	2.4	....	....	....
(g) Other business licenses	21.4	20.5	17.1	15.0	15.7
(h) Special property	9.0	7.4	8.6	8.2	8.3
6. Net income taxes	.6	8.3	10.3	9.1	8.9
(a) Individual	....	....	....	....	....
(b) Corporation	....	....	....	....	....
(c) Not allocable	....	....	....	....	....
7. Death and gift taxes	7.8	7.7	7.0	7.3	7.0
8. Poll taxes	.9	.4	.9	.7	.3
9. Miscellaneous licenses	....	....	....	....	....
10. Documentary and stock registration	....	....	....	....	....
11. All other taxes	....	2.3	2.1	2.8	2.1

Tax	1925	1926	1927	1928
	Percent	*Percent*	*Percent*	*Percent*
Total State taxes	100.0	100.0	100.0	100.0
1. General and selective property taxes	27.5	25.7	23.0	21.7
2. Severance taxes	....	....	....	....
3. Motor-vehicle taxes	20.0	19.7	18.7	18.4
4. Sales taxes	11.4	12.8	16.1	17.4
(a) General sales	....	....	....	....
(b) Motor fuel	11.4	12.8	16.1	17.4
(c) Alcoholic beverage	....	....	....	....
(d) Tobacco products	....	....	....	....
(e) Admissions and amusements	....	....	....	....
(f) Soft drinks	....	....	....	....
(g) Oleomargarine	....	....	....	....
5. Taxes on specific businesses	23.3	22.6	22.0	21.0
(a) Public utilities	....	....	....	....
(b) Insurance	....	....	....	....
(c) Chain stores	....	....	....	....
(d) Betting or racing	....	....	....	....
(e) Corporation (franchise)	....	....	....	....
(f) Alcoholic beverage licenses	....	....	....	....
(g) Other business licenses	16.4	16.1	15.8	15.0
(h) Special property	6.9	6.5	6.2	6.0
6. Net income taxes	7.9	9.2	10.1	10.5
(a) Individual	....	....	....	....
(b) Corporation	....	....	....	....
(c) Not allocable	....	....	....	....
7. Death and gift taxes	6.6	6.2	6.6	7.3
8. Poll taxes	.3	.3	.2	.2
9. Miscellaneous licenses	.7	.7	.7	.7
10. Documentary and stock registration	....	....	....	....
11. All other taxes	2.5	3.0	2.6	2.8

TABLE 36.—*Trends in State tax collections, 1915–40*—Continued

Tax	1929	1930	1931	1932
	Percent	*Percent*	*Percent*	*Percent*
Total State taxes	100.0	100.0	100.0	100.0
1. General and selective property taxes	18.0	16.4	18.2	18.0
2. Severance taxes			1.3	1.0
3. Motor vehicle taxes	17.8	16.9	16.9	17.4
4. Sales taxes	22.1	24.1	27.6	29.2
(a) General sales		.1	.4	.4
(b) Motor fuel	22.1	23.5	26.3	27.6
(c) Alcoholic beverage			(1)	.1
(d) Tobacco products		.6	.7	1.0
(e) Admissions and amusements			.1	.1
(f) Soft drinks			(1)	(1)
(g) Oleomargarine			(1)	(1)
5. Taxes on specific businesses	19.6	18.6	14.7	16.0
(a) Public utilities			5.4	5.7
(b) Insurance			3.5	4.0
(c) Chain stores			(1)	.1
(d) Betting or racing			.1	.1
(e) Corporation (franchise)			5.2	5.5
(f) Alcoholic beverage licenses				
(g) Other business licenses	14.0	14.1	.5	.6
(h) Special property	5.6	4.6		
6. Net income taxes	10.5	11.1	9.8	8.2
(a) Individual			4.2	4.0
(b) Corporation			5.6	4.2
(c) Not allocable				
7. Death and gift taxes	7.6	8.7	9.2	7.9
8. Poll taxes	.2	.2	.2	.2
9. Miscellaneous licenses	.7	.7	.7	.7
10. Documentary and stock registration			1.4	1.2
11. All other taxes	3.5	3.3	.1	.1

Tax	1933	1934	1935	1936
	Percent	*Percent*	*Percent*	*Percent*
Total State taxes	100.0	100.0	100.0	100.0
1. General and selective property taxes	16.5	13.8	11.2	8.7
2. Severance taxes	.8	1.0	1.2	1.3
3. Motor vehicle taxes	17.6	15.4	14.6	13.7
4. Sales taxes	32.6	42.0	47.4	47.0
(a) General sales	.9	8.8	12.8	13.9
(b) Motor fuel	30.0	28.5	27.8	26.2
(c) Alcoholic beverage	0.4	3.2	5.2	4.9
(d) Tobacco products	1.2	1.2	1.3	1.7
(e) Admissions and amusements	.1	.1	.2	.2
(f) Soft drinks	(1)	.1	.1	(1)
(g) Oleomargarine	(1)	(1)	(1)	(1)
5. Taxes on specific businesses	15.1	13.7	12.0	12.1
(a) Public utilities	5.6	4.7	3.1	2.9
(b) Insurance	3.9	3.4	3.1	2.8
(c) Chain stores	(1)	.1	.1	.2
(d) Betting or racing	.1	.2	.4	.4
(e) Corporation (franchise)	4.7	3.9	3.6	4.0
(f) Alcoholic beverage licenses	.2	.9	1.3	1.4
(g) Other business licenses	.5	.5	.4	.4
(h) Special property				
6. Net income taxes	7.0	6.5	7.2	10.1
(a) Individual	3.7	4.0	4.7	5.8
(b) Corporation	3.3	2.5	2.5	4.3
(c) Not allocable				
7. Death and gift taxes	7.3	4.7	4.5	4.5
8. Poll taxes	.2	.2	.3	.3
9. Miscellaneous licenses	.8	.7	.7	.6
10. Documentary and stock registration	2.0	1.8	.9	1.5
11. All other taxes	.1	.1	.1	.1

[1] Less than 0.05 percent.

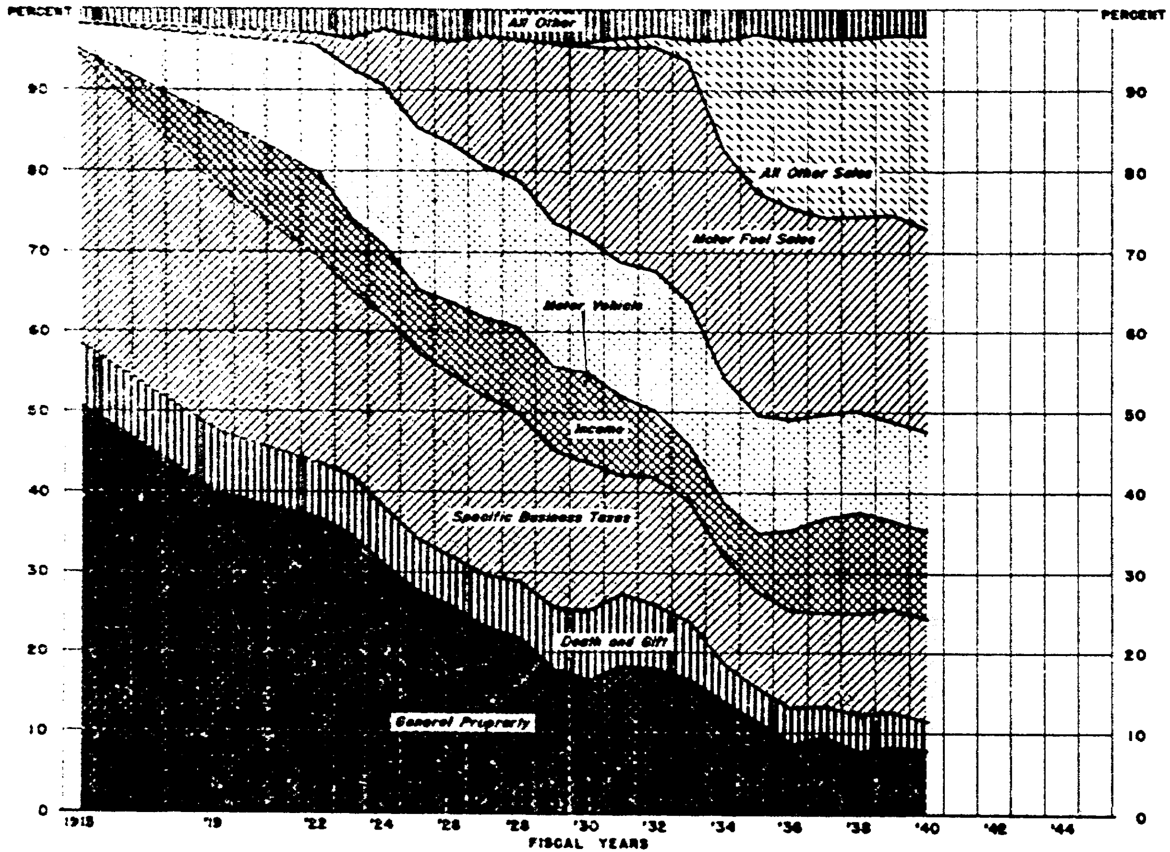
TABLE 36.—*Trends in State tax collections, 1915-40*—Continued

Tax	1937	1938	1939	1940
	Percent	*Percent*	*Percent*	*Percent*
Total State taxes	100.0	100.0	100.0	100.0
1. General and selective property taxes	9.5	7.8	8.3	7.9
2. Severance taxes	1.6	2.0	1.6	1.6
3. Motor vehicle taxes	12.9	12.4	12.4	12.3
4. Sales taxes	46.4	46.2	47.7	49.1
(*a*) General sales	14.1	14.2	14.2	14.7
(*b*) Motor fuel	24.5	24.4	25.8	25.3
(*c*) Alcoholic beverage	5.7	5.6	5.6	6.0
(*d*) Tobacco products	1.7	1.8	1.9	2.9
(*e*) Admissions and amusements	.3	.2	.2	.2
(*f*) Soft drinks	.1	.1	.1	.1
(*g*) Oleomargarine	(1)	(1)	(1)	(1)
5. Taxes on specific businesses	11.8	12.5	12.8	12.8
(*a*) Public utilities	2.9	3.7	3.6	3.7
(*b*) Insurance	2.5	2.7	3.1	3.1
(*c*) Chain stores	.2	.2	.2	.2
(*d*) Betting or racing	.4	.3	.4	.4
(*e*) Corporation (franchise)	4.0	3.4	3.3	3.4
(*f*) Alcoholic beverage licenses	1.4	1.6	1.7	1.8
(*g*) Other business licenses	.4	.4	.4	.4
(*h*) Special property	------	------	------	------
6. Net income taxes	11.9	12.8	11.1	11.1
(*a*) Individual	6.2	6.9	5.9	5.6
(*b*) Corporation	4.7	5.5	4.2	4.3
(*c*) Not allocable	1.0	.4	1.0	1.1
7. Death and gift taxes	3.8	4.6	4.3	3.5
8. Poll taxes	.2	.2	.2	.2
9. Miscellaneous licenses	.5	.6	.6	.6
10. Documentary and stock registration	1.3	.9	.8	.8
11. All other taxes	.1	.1	.1	.1

[1] Less than 0.05 percent.

NOTE.—For sources and explanatory footnotes, see table 35.

PERCENTAGE DISTRIBUTION OF STATE TAX REVENUES BY SOURCES, 1915 – 1940*



Source Table 36
*Exclusive of unemployment compensation taxes and inclusive of local shares

CHART 7.

TABLE 37.—*Local property and other tax collections, 1915–40*

Year	Total local tax collections [1]	Local property taxes [2]	Other local taxes [2]	Percentage of property taxes to total [2]	Percentage of property taxes to total in cities of over 100,000 [3]
	Millions	*Millions*	*Millions*	*Percent*	*Percent*
1915	$1,318	$1,255	$63	95.2	
1919	2,395	2,268	127	94.7	
1922	3,157	2,974	183	94.2	93.0
1923	3,285	3,094	191	94.2	92.6
1924	3,602	3,389	213	94.1	92.2
1925	3,811	3,582	229	94.0	91.9
1926	4,135	3,883	252	93.9	91.7
1927	4,367	4,101	266	93.9	92.3
1928	4,641	4,353	288	93.8	92.1
1929	4,819	4,250	299	93.8	91.2
1930	5,018	4,702	316	93.7	91.6
1931	4,805	4,497	308	93.6	93.2
1932	4,657	4,361	296	93.6	93.3
1933	4,210	3,941	269	93.6	93.8
1934	4,160	3,885	275	93.4	92.3
1935	4,299	3,998	301	93.0	90.2
1936	4,290	3,968	322	92.5	88.4
1937	4,370	4,020	350	92.0	
1938	4,344	3,975	369	91.5	
1939	4,300	3,913	387	91.0	
1940	4,365	3,972	39[illegible]	91.0	

[1] Data for 1922 and 1932 are from Bureau of the Census, Wealth, Public Debt, and Taxation, 1922; and Financial Statistics of State and Local Governments, 1932. Figures for 1938 and 1939 are estimates prepared by the staff of the Committee on Intergovernmental Fiscal Relations. All other data are estimates of the National Industrial Conference Board. Sources for specific years are as follows:

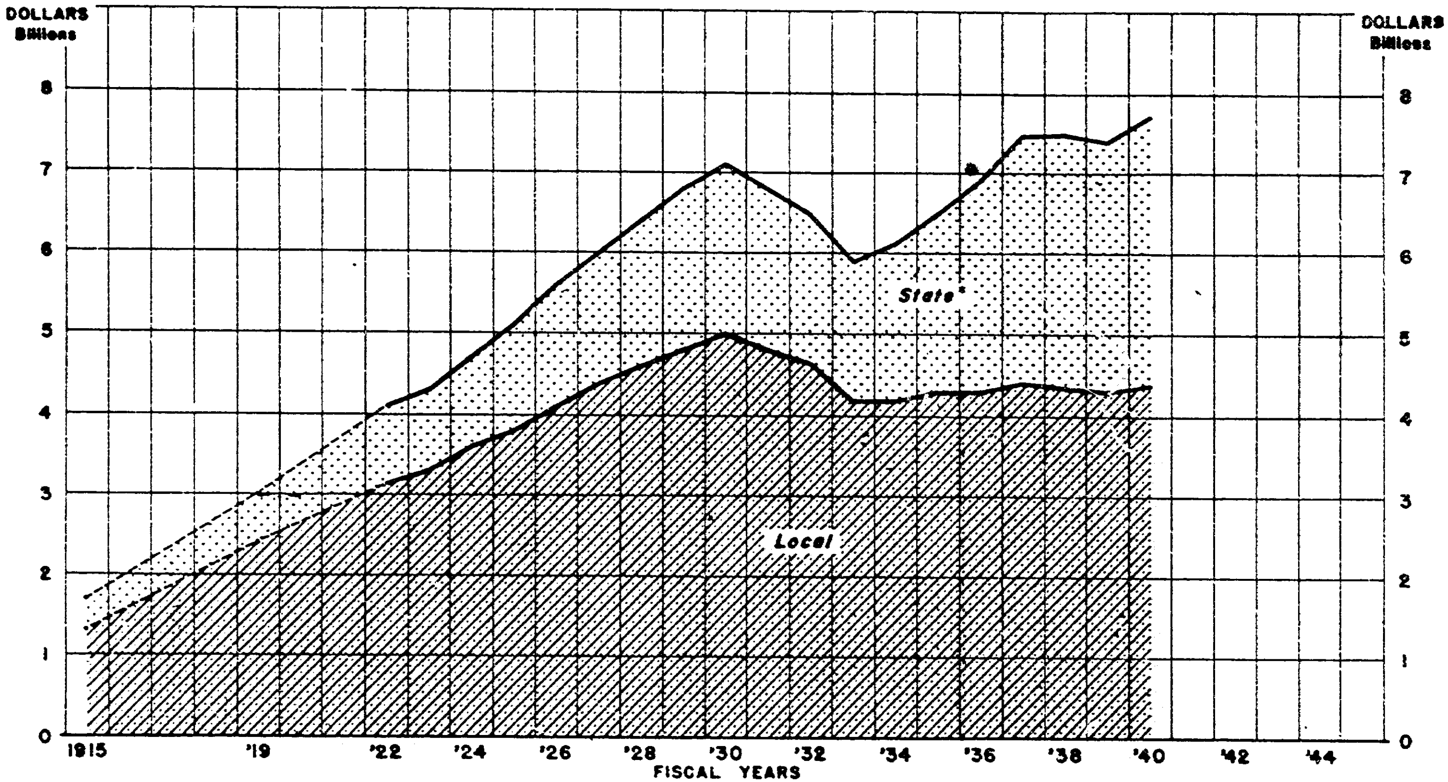
1915: Taxation and National Income, Research Report No. 55, October 1922, p. 28.
1919: Cost of Government in the United States, 1929-30, p. 77.
1923-35: Cost of Government in the United States, 1935-37, p. 30.
1936-37: Conference Board Economic Record, Sept. 15, 1939, p. 96.
1940: Conference Board Economic Record, Dec. 24, 1941, p. 563.

Figures reported therein have been adjusted by deducting the local share of State-collected taxes, amounting to $205,800,000.

[2] Estimated except for 1922 and 1932.

[3] Bureau of the Census, Financial Statistics of Cities, 1922-36.

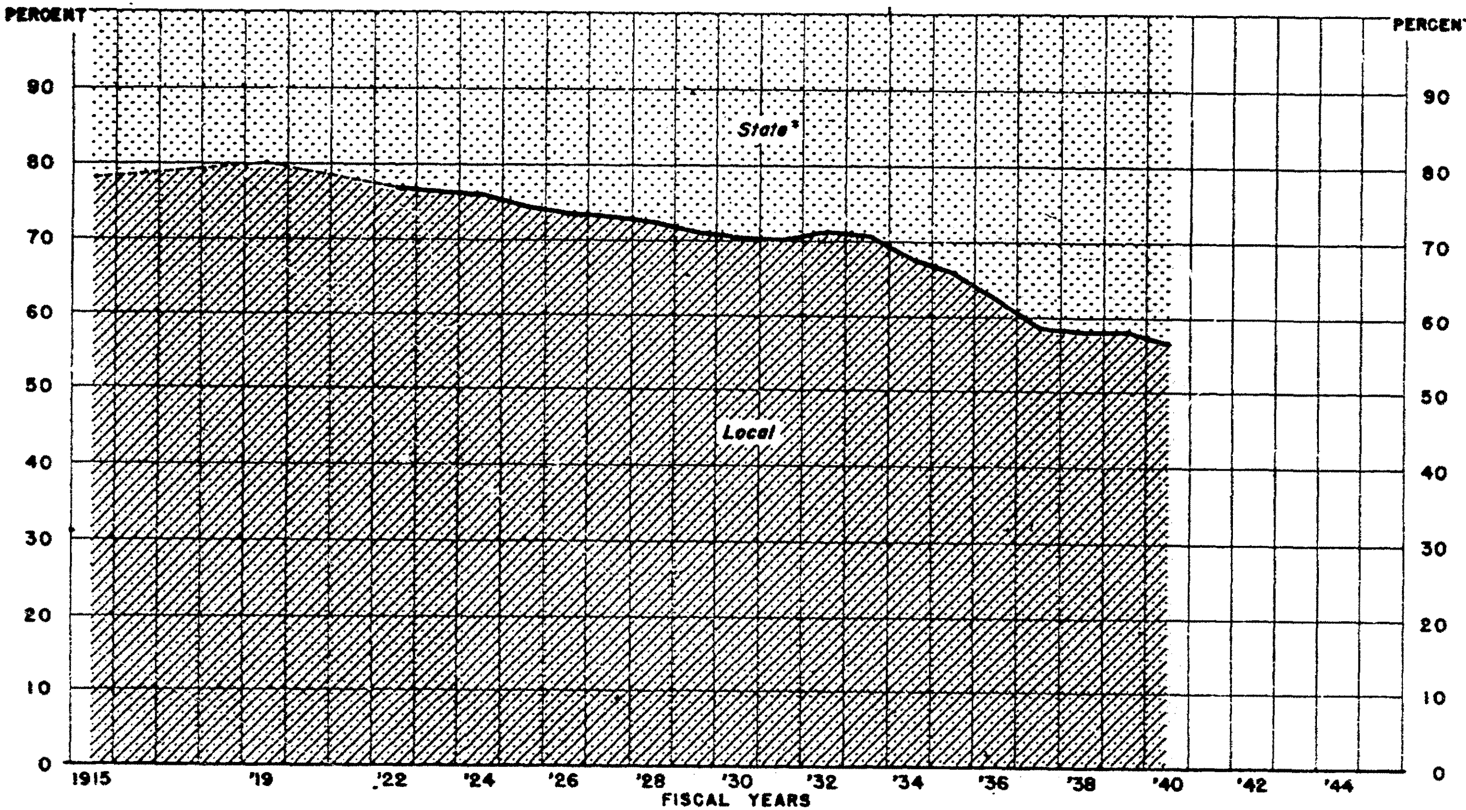
TRENDS IN STATE AND LOCAL TAX COLLECTIONS, 1915 - 1940



Source: Tables 35(state) and 37(local)
*Exclusive of unemployment compensation taxes and inclusive of local shares

CHART 8.

PERCENTAGE DISTRIBUTION OF STATE AND LOCAL TAX COLLECTIONS, 1915 - 1940



Source: Table 36(state) and 37(local)
*Exclusive of unemployment compensation taxes and inclusive of local shares.

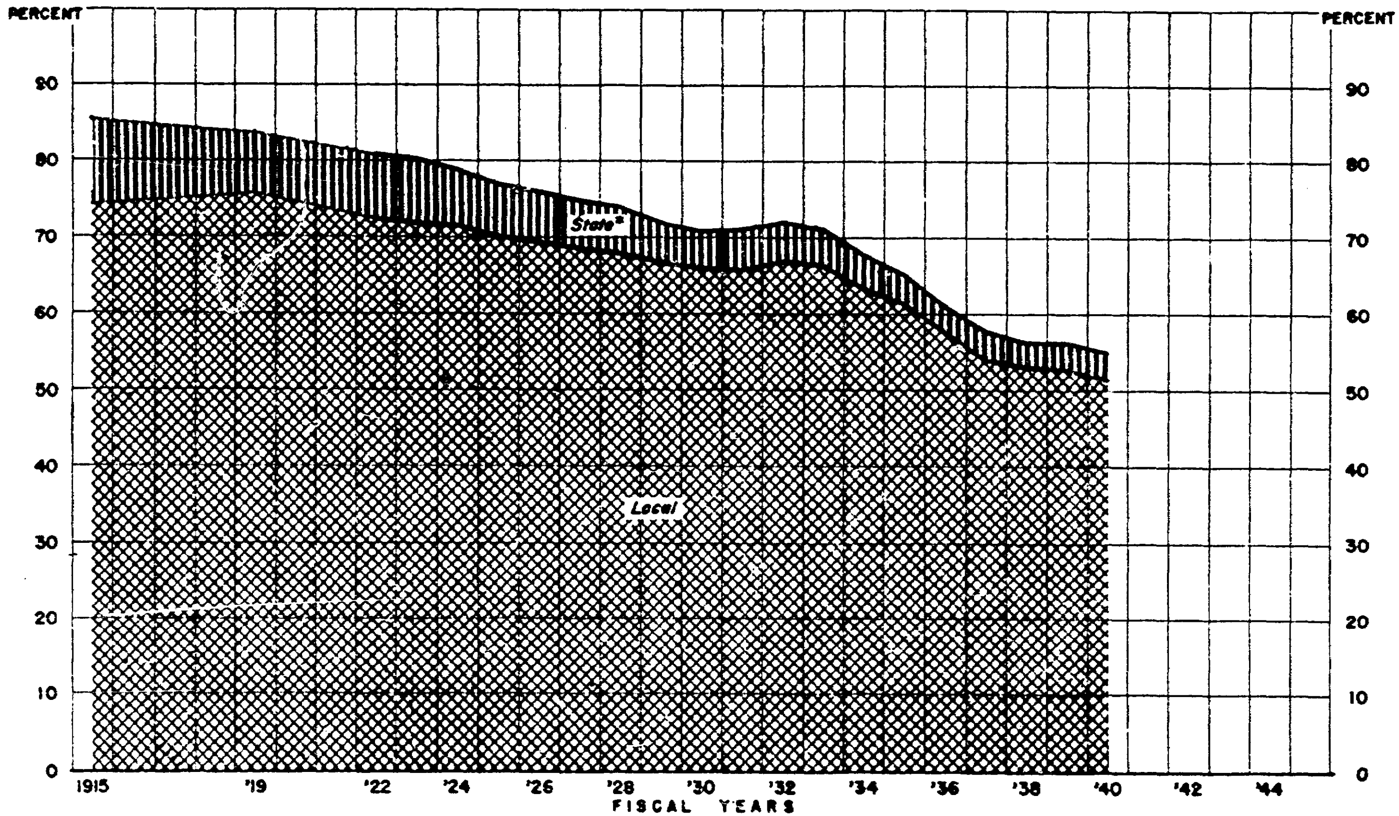
CHART 9.

TABLE 38.—*State and local property tax collections in relation to all State and local tax collections, for selected years, 1915–40* [1]

Year	Amount of collections (millions)			Percentage distribution of collections (percent)		
	Property taxes [2]	All other State and local taxes [3]	Total State and local taxes	Property taxes	All other State and local taxes	Total State and local taxes
1915	$1,410.9	$245.0	$1,685.9	85.5	14.5	100.0
1919	2,505.2	483.8	2,989.0	83.8	16.2	100.0
1922	3,322.3	782.0	4,104.3	80.9	19.1	100.0
1923	3,446.5	858.0	4,304.5	80.1	19.9	100.0
1924	3,740.6	1,000.1	4,740.7	78.9	21.1	100.0
1925	3,940.6	1,175.7	5,116.3	77.0	23.0	100.0
1926	4,258.7	1,341.0	5,599.7	76.1	23.9	100.0
1927	4,471.4	1,503.1	5,974.5	74.8	25.2	100.0
1928	4,734.2	1,662.9	6,397.1	74.0	26.0	100.0
1929	4,870.2	1,899.6	6,769.8	71.9	28.1	100.0
1930	5,017.2	2,078.3	7,125.5	70.8	29.2	100.0
1931	4,868.4	1,978.3	6,846.7	71.1	28.9	100.0
1932	4,696.2	1,822.3	6,518.5	72.0	28.0	100.0
1933	4,226.1	1,708.3	5,934.4	71.2	28.8	100.0
1934	4,158.3	1,981.1	6,139.4	67.7	32.3	100.0
1935	4,246.1	2,269.8	6,515.9	65.2	34.8	100.0
1936	4,195.5	2,712.7	6,908.2	60.7	39.3	100.0
1937	4,311.9	3,146.9	7,458.8	57.8	42.2	100.0
1938	4,219.0	3,270.8	7,489.8	56.3	43.7	100.0
1939	4,172,2	3,236.6	7,408.8	56.3	43.7	100.0
1940	4,236.7	3,471.2	7,707.9	55.0	45.0	100.0

[1] Excluding unemployment compensation taxes.
[2] "Local property taxes" in table 37 plus "General and selective property taxes" in table 35.
[3] "Total State taxes" in table 35, minus "General and selective property taxes" in table 35, plus "Other local taxes" in table 37.

STATE AND LOCAL PROPERTY TAXES
AS PERCENTAGE OF TOTAL STATE AND LOCAL TAX COLLECTIONS



Source: Table 38
*Exclusive of unemployment compensation taxes and inclusive of local shares

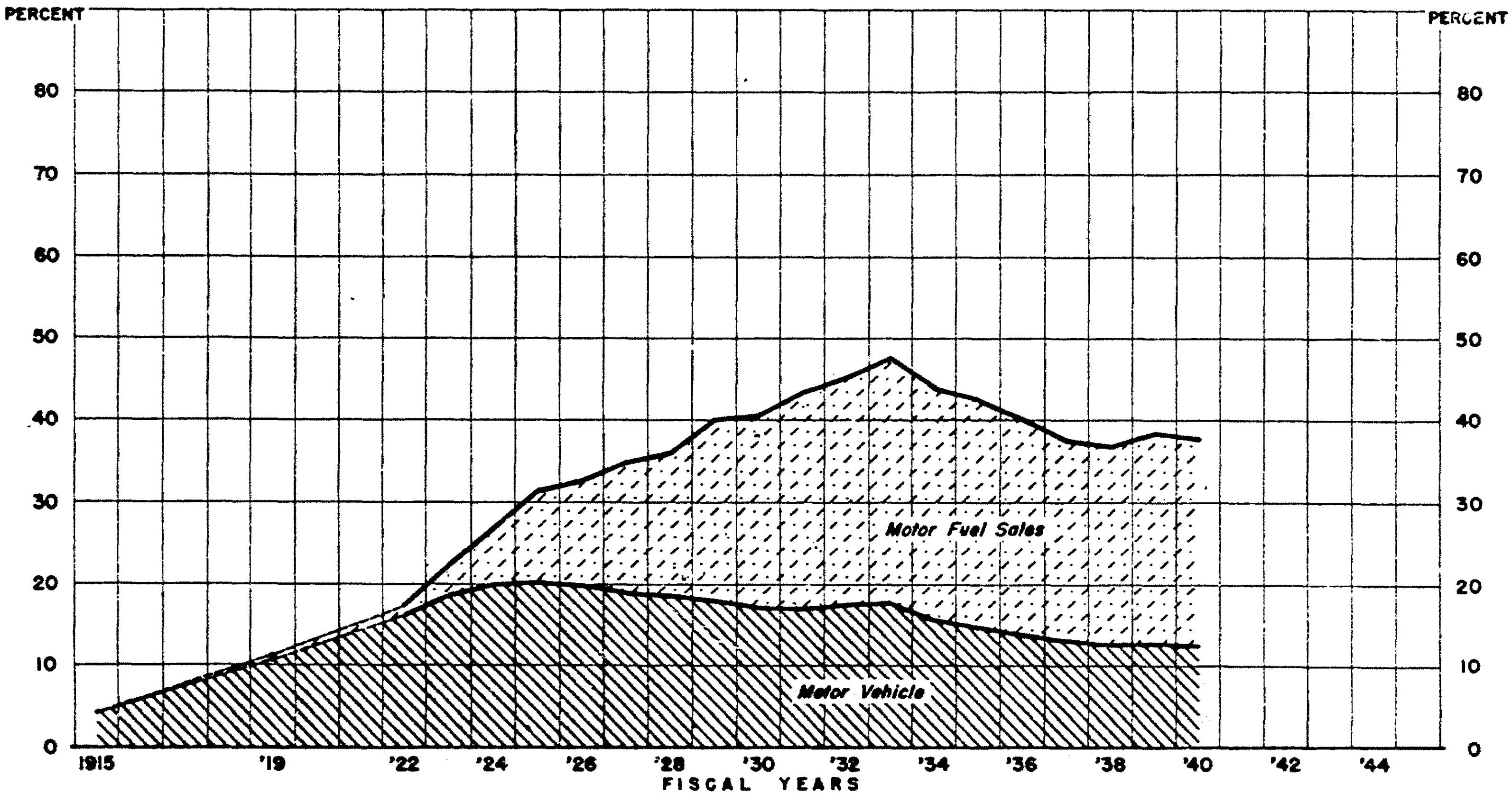
CHART 10.

TABLE 39.—*Taxes paid by motor vehicle owners in relation to total State tax collections for selected years, 1915–40* [1]

Year	Amount of collections (millions)			Percentage distribution of collections (percent)		
	Taxes paid by motor vehicle owners [2]	All other State taxes [3]	Total State taxes [4]	Taxes paid by motor vehicle owners	All other State taxes	Total State taxes
1915	$14.9	$353.0	$367.9	4.1	95.9	100.0
1919	65.7	528.3	594.0	11.1	88.9	100.0
1922	164.7	782.6	947.3	17.4	82.6	100.0
1923	227.6	791.9	1,019.5	22.3	77.7	100.0
1924	305.9	832.8	1,138.7	26.9	73.1	100.0
1925	409.0	896.3	1,305.3	31.3	68.7	100.0
1926	475.9	988.8	1,464.7	32.5	67.5	100.0
1927	559.9	1,047.6	1,607.5	34.8	65.2	100.0
1928	627.5	1,128.6	1,756.1	35.7	64.3	100.0
1929	779.1	1,171.7	1,950.8	39.9	60.1	100.0
1930	850.4	1,257.1	2,107.5	40.4	59.6	100.0
1931	880.7	1,161.0	2,041.7	43.1	56.9	100.0
1932	837.3	1,024.2	1,861.5	45.0	55.0	100.0
1933	820.9	903.5	1,724.4	47.6	52.4	100.0
1934	869.9	1,109.5	1,979.4	43.9	56.1	100.0
1935	939.7	1,277.2	2,216.9	42.4	57.6	100.0
1936	1,046.4	1,571.8	2,618.2	40.0	60.0	100.0
1937	1,156.5	1,932.3	3,088.8	37.4	62.6	100.0
1938	1,155.7	1,990.1	3,145.8	36.7	63.3	100.0
1939	1,187.2	1,921.6	3,108.8	38.2	61.8	100.0
1940	1,257.2	2,085.7	3,342.9	37.6	62.4	100.0

[1] Excluding unemployment compensation taxes and including local shares.
[2] "Motor-vehicle taxes" in table 35 plus "Motor-fuel taxes" in table 35.
[3] Sum of items other than "Motor-vehicle taxes" and "Motor-fuel taxes" in table 35.
[4] From table 35.

TAXES PAID BY MOTOR VEHICLE OWNERS
AS PERCENTAGE OF TOTAL STATE TAX COLLECTIONS 1915-1940



Source: Table 39

CHART 11.

TABLE 40.—*Federal and estimated State and local general government expenditures, 1941*

[In thousands]

Function	Expenditures from own sources [1]			
	Federal	State	Local	Total
General administrative, legislative, and judicial	$438,590	$185,184	$595,653	$1,210,427
National defense	6,685,427			6,685,427
Police and other protection	46,476	140,110	571,697	758,283
Education	165,195	908,527	1,473,582	2,547,304
Highways and streets	205,005	1,001,771	467,065	1,673,841
Agriculture and natural resources	1,287,676	89,198	55,186	1,432,060
Relief, welfare, and social security [2]	3,101,840	1,509,734	349,752	4,961,326
Health and hospitals	68,755	293,117	271,743	633,615
Interest	1,098,135	116,901	462,659	1,677,695
All other	740,954	335,289	895,939	1,972,182
Total expenditures	13,838,053	4,579,831	[3] 4,940,597	[3] 23,358,481
Debt retirement	40,462	256,709	621,000	918,171
Total expenditures, including debt retirement	13,878,515	4,836,540	[3] 5,561,597	[3] 24,276,652

Function	Intergovernmental grants [4]				
	Federal to State	Federal to local	State to local	Local to State	State and local to Federal
General administrative, legislative, and judicial	$4,520	$5,498	$59		
National defense					
Police and other protection			8,941		
Education	100,984	29,412	735,439		
Highways and streets	183,839	18,194	341,707	$4,211	
Agriculture and natural resources	21,801	13,840	814		
Relief, welfare, and social security [2]	396,843	1,124	406,990	12,189	
Health and hospitals	29,607	4,552	8,223	695	
Interest			8,714	5,358	[5] $12,070
All other	9,500	63,987	195,641	22,686	
Total expenditures	750,094	136,607	1,706,528	45,139	12,070
Debt retirement			39,786	23,545	[6] 24,043
Total expenditures, including debt retirement	750,094	136,607	1,746,314	68,684	36,113

Function	Expenditures for own functions: Amount [7]			
	Federal	State	Local	Total
General administrative, legislative, and judicial	$426,057	$189,645	$601,210	$1,216,912
National defense	6,685,427			6,685,427
Police and other protection	46,476	131,169	580,638	758,283
Education	33,600	274,072	2,238,433	2,546,105
Highways and streets	1,023	848,114	822,755	1,671,892
Agriculture and natural resources	1,248,497	113,185	69,840	1,431,522
Relief, welfare, and social security [2]	2,699,021	1,511,776	745,677	4,956,474
Health and hospitals	33,378	315,196	283,823	632,397
Interest	1,110,205	110,945	456,545	1,677,695
All other	660,993	171,834	[3] 930,202	1,763,029
Total expenditures	12,944,677	3,665,936	[3] 6,720,123	[3] 23,330,736
Debt retirement	64,505	238,368	615,298	918,171
Total expenditures, including debt retirement	13,009,182	3,904,304	[3] 7,344,421	[3] 24,257,907

See footnotes at end of table.

TABLE 40.—*Federal and estimated State and local general government expenditures, 1941*—Continued

Function	Expenditures for own functions: Percentage distribution by functions for each level of government [7]			
	Total	Federal	State	Local
General administrative, legislative, and judicial	5.0	3.3	4.9	8.2
National defense	27.6	51.4		
Police and other protection	3.1	.4	3.4	7.9
Education	10.5	.3	7.0	30.5
Highways and streets	6.9	(8)	21.7	11.2
Agriculture and natural resources	5.9	9.6	2.9	1.0
Relief, welfare, and social security [2]	20.4	20.7	38.7	10.2
Health and hospitals	2.6	.3	8.1	3.9
Interest	6.9	8.5	2.8	6.2
All other	7.3	5.1	4.4	12.7
Total expenditures	96.2	99.5	93.9	91.6
Debt retirement	3.8	.5	6.1	8.4
Total expenditures, including debt retirement	100.0	100.0	100.0	100.0

Function	Expenditures for own functions: Percentage distribution by levels of Government for each function [7]			
	Total	Federal	State	Local
General administrative, legislative, and judicial	100.0	35.0	15.6	49.4
National defense	100.0	100.0		
Police and other protection	100.0	6.1	17.3	76.6
Education	100.0	1.3	10.8	87.9
Highways and streets	100.0	.1	50.7	49.2
Agriculture and natural resources	100.0	87.2	7.9	4.9
Relief, welfare, and social security [2]	100.0	54.5	30.5	15.0
Health and hospitals	100.0	5.3	49.8	44.9
Interest	100.0	66.2	6.6	27.2
All other	100.0	37.5	9.7	52.8
Total expenditures	100.0	55.5	15.7	28.8
Debt retirement	100.0	7.0	26.0	67.0
Total expenditures, including debt retirement	100.0	53.6	16.1	30.3

[1] Excludes payments from funds received from other public units; includes payments to other public units.
[2] Relief, welfare, and social-security expenditures include net additions to reserves as follows: Federal, $693,782,000; State, $540,705,000; local, $3,199,000.
[3] Total local expenditures have been decreased by $202,679,000, the amount of unspecified Federal and State aid to local governments. By definition, this amount cannot be allocated to the functions, the aggregate of which is necessarily reduced by this sum to show true total expenditures.
[4] "Intergovernmental grants" shown do not include Federal grants to territories totaling $18,745,000 which sum, however, has been deducted from "Expenditures for own functions."
[5] State and local grants to the Federal Government for interest include: State, $2,600,000; local, $9,470,000.
[6] State and local grants to the Federal Government for debt retirement include: State, $2,100,000; local $21,943,000.
[7] Excludes payments to other public units; includes payments from funds received from other public units.
[8] Less than 0.05 percent.

Source: Bureau of the Census, Financing Federal, State, and Local Governments, 1941.

TABLE 41.—*Governmental expenditures in the United States for selected years, 1925–41* [1]

Year	Total	Federal		State		Local	
		Amount	Percent of total	Amount	Percent of total	Amount	Percent of total
	Millions	*Millions*		*Millions*		*Millions*	
1925	$9,869	$2,801	28.4	$1,493	15.1	$5,575	56.5
1928	10,972	2,798	25.5	1,774	16.2	6,400	58.3
1930	11,943	3,152	26.4	2,170	18.2	6,621	55.4
1931	12,390	3,560	28.7	2,298	18.5	6,532	52.7
1932	13,129	4,434	33.8	2,257	17.2	6,438	49.0
1933	11,284	3,793	33.6	2,067	18.3	5,424	48.1
1934	13,604	5,947	43.7	2,044	15.0	5,613	41.3
1935	15,011	6,933	46.2	2,230	14.9	5,848	38.9
1936	17,009	8,611	50.6	2,433	14.3	5,965	35.1
1937	17,187	8,386	48.8	2,851	16.6	5,950	34.6
1938	17,050	7,526	44.1	3,373	19.8	6,151	36.1
1939	19,202	9,142	47.6	3,810	19.8	[2] 6,250	32.5
1940	19,679	9,446	48.0	[2] 3,883	19.7	[2] 6,350	32.3
1941	23,582	13,282	56.3	----------	----------	----------	----------
EXCLUSIVE OF PAY-ROLL TAXES [3]							
1937	$16,921	$8,121	48.0	$2,850	16.8	$5,950	35.2
1938	16,312	6,993	42.9	3,171	19.4	6,148	37.7
1939	18,139	8,532	47.0	3,360	18.5	[2] 6,247	34.4
1940	18,516	8,786	47.5	[2] 3,383	18.3	[2] 6,347	34.2
1941	22,340	12,497	55.9	----------	----------	----------	----------

[1] Grants-in-aid are counted as expenditures of the first disbursing government.
[2] Preliminary estimate of Tax Foundation.
[3] Federal expenditures are exclusive of transfers to old-age reserve account and railroad retirement account; State and local expenditures are exclusive of unemployment-compensation payments.

Sources: Treasury Department, Annual Report of the Secretary; Bureau of the Census, Financial Statistics of States; Tax Foundation, Tax Facts and Figures, 1941.

TABLE 42.—*Gross public debt in the United States, 1919 and 1926–41* [1]

[In millions]

Year	Loans outstanding				Warrants outstanding [2]				Total			
	Federal	State	Local	Total	Federal	State	Local	Total	Federal	State[3]	Local	Total
1919	$25,705	$731	$6,311	$32,747	$223	$13	$38	$274	$25,928	$744	$6,349	$33,021
1926	19,784	1,826	11,838	33,448	309	32	72	413	20,093	1,858	11,910	33,861
1927	18,655	1,961	12,774	33,390	237	34	78	349	18,892	1,995	12,852	33,739
1928	17,728	2,110	13,589	33,427	250	34	103	387	17,978	2,144	13,692	33,814
1929	17,067	2,259	14,501	33,827	332	41	99	472	17,399	2,300	14,600	34,299
1930	16,298	2,406	15,579	34,283	141	38	81	260	16,439	2,444	15,660	34,543
1931	16,938	2,606	16,582	36,126	147	60	90	297	17,085	2,666	16,672	36,423
1932	19,618	2,617	17,018	39,253	190	279	118	587	19,808	2,896	17,136	39,840
1933	22,688	2,716	16,391	41,795	206	301	137	644	22,894	3,017	16,528	42,439
1934	27,325	2,966	15,976	46,267	418	265	130	843	27,773	3,231	16,106	47,110
1935	[4] 29,446	3,112	16,165	[4] 48,723	[4] 179	311	120	[4] 610	[4] 29,625	3,423	16,285	[4] 49,333
1936	34,485	3,150	16,350	53,985	357	244	110	711	34,842	3,394	16,460	54,696
1937	37,313	3,022	16,130	56,465	157	238	178	573	37,470	3,260	16,308	57,038
1938	38,049	3,117	16,053	57,209	202	173	141	516	38,251	3,290	16,194	57,735
1939	41,251	3,241	16,385	60,877	240	205	103	548	41,491	3,446	16,488	61,425
1940	43,263	3,296	16,654	63,213	147	268	66	481	43,410	3,564	16,720	63,694
1941	49,399	3,209	16,725	69,259	179	246	36	461	49,578	3,455	16,813	69,761

[1] M. Newcomer, "Analysis of the Nature of American Public Debts, Federal, State, and Local," American Economic Review Supplement, vol. XXVII, No. 1, March 1937. Figures for 1937-41 compiled from Bureau of the Census, State and Local Debts, Financial Statistics of States, Financial Statistics of Cities Over 100,000 Population; Treasury Department, Annual Report of the Secretary; and miscellaneous State reports.
[2] For Federal Government, liabilities of general fund. For State and local governments, checks and warrants outstanding insofar as a record of these could be found.
[3] Gross debt as reported by Bureau of the Census, Financial Statistics of States, less contingent debt, plus warrants outstanding.
[4] Revised from earlier study by Newcomer, op. cit.

TABLE 43.—*Net public debt in the United States, 1919 and 1926–41* [1]

[In millions]

Year	Total amount				Amount per capita			
	Federal	State	Local	Total	Federal	State	Local	Total
1919	$24,005	$324	$4,667	$28,990	$230	$3	$45	$278
1926	19,058	667	8,729	28,454	164	6	75	245
1927	18,034	684	9,555	28,273	153	6	81	240
1928	17,246	785	10,076	28,107	144	7	84	235
1929	16,502	887	10,765	28,154	136	7	89	232
1930	15,711	949	11,866	28,526	128	8	97	233
1931	15,894	1,192	13,489	30,575	128	10	109	247
1932	17,562	1,423	14,253	33,238	141	11	114	266
1933	18,760	1,610	13,394	33,764	149	13	107	269
1934	[2] 18,804	1,729	12,650	[2] 33,183	149	14	100	263
1935	21,390	1,828	12,617	35,835	168	14	99	281
1936	[2] 26,013	1,823	12,792	[2] 40,628	[2] 203	14	100	[2] 317
1937	28,999	1,819	12,478	43,296	225	14	97	336
1938	29,947	1,826	12,274	44,047	230	14	94	338
1939	32,918	1,559	12,578	47,055	252	12	96	360
1940	35,905	1,996	12,734	60,635	272	15	97	384
1941	41,530	1,779	12,685	55,994	312	13	96	421

[1] M. Newcomer, "Analysis of the Nature of American Public Debts, Federal, State, and Local," American Economic Review Supplement, vol. XXVII, No. 1, March 1937. Figures for 1937–41 compiled from Bureau of Census, State and Local Debts, Financial Statistics of States, Financial Statistics of Cities Over 100,000 Population; Treasury Department, Annual Report of the Secretary; and miscellaneous State reports.
[2] Revised from original figures in Newcomer, op. cit.

TABLE 44.—*Productive public debt in the United States, 1919 and 1926–41* [1]

Year	Amount				Percent of total public debt			
	Federal	State	Local	Total	Federal	State	Local	Total
	Millions	*Millions*	*Millions*	*Millions*				
1919	$367	$46	$1,142	$1,555	1.4	6.3	18.1	4.7
1926	629	213	[2] 2,679	[2] 3,521	3.2	11.7	[2] 22.6	[2] 10.5
1927	500	267	[2] 2,935	[2] 3,702	2.7	13.6	[2] 23.0	[2] 11.1
1928	329	293	[2] 3,223	[2] 3,845	1.9	13.9	[2] 23.7	[2] 11.5
1929	342	255	[2] 3,558	[2] 4,155	2.0	11.3	[2] 24.5	[2] 12.1
1930	357	262	[2] 3,963	[2] 4,582	2.2	10.9	[2] 24.8	[2] 13.4
1931	712	296	[2] 4,221	[2] 5,229	4.2	11.4	[2] 25.4	[2] 14.5
1932	1,789	224	[2] 4,216	[2] 6,229	9.1	8.6	[2] 21.8	[2] 15.9
1933	3,154	226	[2] 4,295	[2] 8,375	13.9	8.3	[2] 26.2	[2] 20.0
1934	4,293	225	[2] 4,450	[2] 8,968	15.7	7.6	[2] 27.8	[2] 19.4
1935	[2] 4,569	234	[2] 4,566	[2] 9,369	[2] 15.5	7.5	[2] 28.2	[2] 19.2
1936	[2] 4,299	240	[2] 4,832	[2] 9,371	[2] 12.5	7.6	[2] 29.6	[2] 17.4
1937	4,021	222	4,868	9,091	10.8	7.3	30.2	16.1
1938	4,155	210	5,049	9,414	10.9	6.7	31.4	16.4
1939	3,766	212	5,243	9,221	9.1	6.5	32.0	15.1
1940	3,717	310	5,520	9,547	8.6	9.4	33.1	15.1
1941	3,486	326	5,667	9,479	7.0	10.2	33.9	13.7

[1] M. Newcomer, "Analysis of the Nature of American Public Debts, Federal, State, and Local," American Economic Review Supplement, vol. XXVII, No. 1, March 1937. Figures for 1937–41 compiled from Bureau of Census, State and Local Debts, Financial Statistics of States, Financial Statistics of Cities Over 100,000 Population; Treasury Department, Annual Report of the Secretary; and miscellaneous State reports. Federal figures include Panama Canal loans and investments in governmental corporations and credit agencies. State figures are for public service enterprises, and investments. Local figures are for public service enterprises, including, but not limited to, revenue bonds. Local figures are partly estimated.
[2] Revised from original figures in Newcomer, op. cit.

TABLE 45.—*Percentage of tax revenues required to meet public debt interest charges, 1919 and 1926–41*

Year	Federal	State	Local	Total	Year	Federal	State	Local	Total
1919	13.8	4.5	10.6	12.1	1934	25.6	7.3	16.1	17.6
1926	24.3	6.0	11.6	15.7	1935	22.7	6.3	16.2	17.1
1927	22.6	5.7	11.9	15.0	1936	19.0	4.7	16.3	15.5
1928	21.8	5.6	12.0	14.4	1937	17.0	3.6	15.9	13.1
1929	19.2	5.7	12.3	13.6	1938	15.3	3.3	13.5	11.6
1930	18.2	5.6	12.5	13.3	1939	17.2	3.0	14.8	12.4
1931	21.8	6.2	14.3	15.0	1940	18.4	3.0	13.6	12.4
1932	31.8	6.8	15.5	17.5	1941	14.2	2.7	14.8	11.3
1933	34.4	7.7	16.4	19.1					

Sources: M. Newcomer, "Analysis of the Nature of American Public Debts, Federal, State, and Local," American Economic Review Supplement, vol. XXVII, No. 1, March 1937. Figures for 1937–41 compiled from Bureau of Census, State and Local Debts, Financial Statistics of States, Financial Statistics of Cities Over 100,000 Population; Treasury Department, Annual Report of the Secretary; and miscellaneous State reports.

C. Criticism of the Over-All Tax System

The most prevalent criticisms of the over-all tax system are those which contend that it runs counter to sound economic objectives. These criticisms will be discussed later in the sections on fiscal policy. In addition, several criticisms of the system, more institutional in character, may be briefly discussed here.

It is contended that the over-all tax system is inadequate as to yield. The considerable growth of the public debt during the thirties is cited to support this contention. The States, and particularly the large municipalities, have complained that their available sources of support are no longer adequate to meet their responsibilities. It is quite possible that a modern nation in our situation lacks both the discipline and the ingenuity to divert into the public treasury the means required to provide the services demanded of government. The claims of pressure groups have to be weighed in the light of this possibility. So also do the claims of economic objectives upon tax policy. Unless we are to accept the extreme view that borrowing is not only easier but also better than taxation, even to care for normal repetitive operations of government, considerations of adequacy must be given very substantial weight in the determination of tax policy. Economic ends may call for the abolition of sales taxes and property taxes. Considerations of adequacy (and administrative practicability under conditions of economic mobility) suggest that these taxes will continue to have an important place in the tax system.

Our system of personal taxation leaves much to be desired, both as to adequacy and equity. The fact that the income tax, even under the 1941 act, will reach less than one-quarter of the income recipients of the country is significant.[3] As someone has phrased it, we started out in this country objecting to taxation without representation and we have arrived at a system of representation without (direct) taxation. As to equity, the conspicuous shortcoming is the loopholes. As rates mount, the allowance of exemptions and deductions that split personal income into segments and greatly reduce the taxable portion, becomes increasingly objectionable. The war might be made the occasion for grafting some very desirable changes onto our revenue system: reduced exemptions, collection at the source, and elimination of loopholes. These would be clear gains of the first order and should be retained when the war is over.

[3] Since this was written the number has been substantially increased by the 1942 act.

Against the tax system as a whole, it is argued that certain taxes now used at various governmental levels are unsuited to the jurisdiction employing them. It is easy to demonstrate that the net income tax is not well adapted for general use by local governments. Evidence will be submitted later to show that the tobacco tax is not very suitable for State administration, and that the gasoline tax and motor vehicle-license taxes are so well adapted to State and local use that the Federal Government, which in this instance has only a small advantage, if any, should retire from these fields. The general property tax, though widely condemned, has the great merit that it can be locally administered, and as to real estate, tolerably well administered (with some State assistance). The property tax is in a very real sense a bulwark of local fiscal independence. Although these criticisms of the tax system have some validity, the specific features and tendencies criticized are difficult to correct. Some suggestions for changes will be made later.

The tax system is also criticized because of duplication in Federal and State taxation. This criticism is the subject of much of this entire report and needs no elaboration at this point. Were we to hold the Constitutional Convention of 1787 now, it is possible that much duplication could be avoided. Perhaps some duplication can be eliminated even now, in the face of established institutions and vested interests. In the interest of realism, however, we must recognize that relying upon forbearance has not prevented growing duplication in the past. Duplication is not necessarily bad. Its chief objections are that it creates excessive administrative costs and results in an unfair total burden on some taxpayers. As to the first, something can be done to reduce costs even without the elimination of duplication. As to the second, the overlapping burdens may create inequity, although much of the alleged injustice simmers down to a difference of opinion as to who should bear taxes. Certainly neither the States nor the Federal Government have ever levied taxes without regard for the burdens imposed by the other. In the case of the States, the taxpayer is also protected by the very general fear of migration.

D. Fiscal Policy in the War and Post-War Periods

1. NATURE OF THE PROBLEM

Fiscal policy has developed from obscurity to a subject of absorbing interest in a few brief years of depression and war. The subject is concerned with both public expenditure and taxation, and its implications for intergovernmental fiscal relations require a brief examination of fiscal policy problems in this study.

It is impossible to predict with much confidence what the post-war period will be like, but we do know that the war period is one that requires maximum devotion of national energy to winning the war and maximum use of the fiscal system to avoid both excessive indebtedness and inflation. In many respects, the economic objectives of the pre-war period are now reversed. We are at present interested in using the tax system not to stimulate consumption, but to curtail purchasing power to the fullest extent consistent with the maintenance of human resources.

(*a*) *Post-war economic pattern.*

While we are unable to predict post-war developments with any certainty, it seems quite plausible that in the event of a military victory for the United Nations, economic events will develop as follows:

1. The immediate post-war period will involve transition pains, but in general will be one of maintained or expanded high levels of economic activity. Pent-up post-war needs at home and claims for rehabilitation abroad will be adequate to maintain high levels of production. Deficits will probably continue during this period though the full productivity of the war revenue system will keep them within some bounds of tolerance.

2. The subsequent post-war period may be like the middle and late twenties, in which case the fiscal problem will not involve great difficulties. The generally accepted view, however, seems to be that this period is likely to resemble the thirties. This does not mean that the period will necessarily be one of unemployment and hardship. It does mean that the Government will have to play a prominent role in keeping productivity at high levels. If the problems of the thirties are again confronted in the post-war era it is to be hoped that the improvised program of the former period can be much improved. Although some of these matters are not strictly within the field of intergovernmental relations, they are so significant for this field that a few comments concerning the proper approaches to the post-war fiscal problem seem in order. Taking the generally accepted view that unemployment and idle plant capacity might become a very serious problem after the war, what should be contemplated as a program to meet such a contingency?

(*b*) *The maintenance of full employment and business confidence.*

The Government should and in all probability will underwrite the maintenance of a high level of economic opportunity and as full use of resources and plant capacity in the United States as possible. It should do so by public investments, selected and budgeted to pay for themselves over the period of their own usefulness as far as this can be done. This means that expenditures must be highly creative in the economic sense. Through direct collections from persons who use services flowing from the investments, and through indirect collections by means of the tax system, each item of outlay should contemplate a closed circle of outgo and intake.

One of the big problems of the post-war era will be that of maintaining confidence within the private sector of the economy. This cannot be done with slogans such as "Let us spend ourselves into prosperity." Such slogans might create more unemployment than they alleviate. The psychology and accounting of sound public investment as a necessary and sensible program to cope with unemployment should be much more acceptable to private business.

It has been frequently contended that the compensatory spending program of the thirties was to a considerable extent self-defeating; that private investment contracted or failed to expand adequately as public investment expanded. If business is made to feel that its welfare is no longer the concern of Government, then the latter will probably have to adjust its program to a continually shrinking private economy. This should not be necessary. Business might be assured that Government will encroach upon the former's preserves only to the extent necessary to maintain reasonably high levels of opportunity and that in doing this only certain areas will be invaded. While it is by no means certain that the effort now being made to develop a conscious countercycle program among individual businessmen will be successful, it is important for business leaders to appreciate that the private economy must deliver opportunity and welfare or be superseded in larger and larger degree. The war has engendered a considerable national unity which should be maintained as far as possible after the war.

(c) *Nature of the depression of the thirties.*

The public expenditure program of the thirties was designed to cope with the depression phase of a business cycle. This was criticized by some economists who saw in the phenomena of the period a secular trend rather than cyclical manifestations. The secular trend was explained in terms of an increase in savings relative to investment opportunities due to such factors as the disappearance of frontiers and the decline in the rate of population growth. This interpretation of modern trends (usually associated with Keynes and Hansen) is by no means established and we should be prepared for very different developments. It is impossible to declare with assurance that private investments will inevitably lag behind savings. Nevertheless, we should be prepared to cope with the kind of future that the "mature economy" theory anticipates. The tragedy of the future may well lie in the lack of courage and foresight to seize what is within our grasp.

Interpretations of the last depression follow two sharply contrasting lines. One holds to the theory of secular stagnation, contending that certain economic and sociological forces, such as the closing of the frontier and the reduced acceleration in the growth of the population, have created a situation in which compensatory deficit spending is necessary to maintain full production. The other holds that stagnation, if any, has been induced politically, the result of a shift in political and economic power. The instrumentalities of politically induced stagnation are onerous taxes and labor unions. Let the captains of industry have the prerogatives and the profit margins that they enjoyed in the twenties and all would be well. This conflict is quite fundamental but there may be a solution of the dilemma. Governmental assistance to the unemployed and the application of the tax system in such manner that inequalities are reduced are stubborn political facts supported by a defensible choice of values irrespective of effects on production. Without deserting the objectives of security, opportunity, and equality, it should be possible to devise a public investment program so limited in area, so sound in its financial plan, and so frank in its statement of purpose that it supplements the private economy and can be reconciled with a lively private incentive.

(d) *Alternative countercycle measures.*

What we should stand ready to inaugurate is some measure or combination of measures designed to close the savings-investment gap, either by increasing private investment, increasing consumption, or by compensatory Government-spending from newly created funds or existing idle funds.

The alternatives may be listed as follows: [3]

(1) Use of taxes and other procedure to redistribute income;
(2) Actions to make incomes, as paid out by business, more nearly equal;
(3) Actions to reduce inequality of income by varying dollar buying power;
(4) Measures to reduce the social pressure to save;
(5) Government spending to balance excess savings;
(6) Measures to increase private-investment opportunity.

A well-balanced program would probably make use of all these means; the first four represent different facets of a direct attack on saving and some effort to shift toward a consumption economy; the last two deal with areas of investment. Some of these approaches will be further examined later; for the moment we shall follow up in more detail the Government-spending approach.

(*e*) *Financing the compensatory spending program.*

The central economic problem concerns the financing of the compensatory spending program. There are a number of alternatives—interest-free money, taxation, or borrowing at the market rate.

The first method is greenbackism in a streamlined form. The most sophisticated proposal is that it should work through the Federal Reserve System; the Secretary of the Treasury would be given power to request the Reserve Banks to make interest-free loans to the Government. Assuming that it was linked with proper spending disciplines, such a scheme might be the answer to many of our debt problems. However, until it can be made understandable to a much wider section of the public, the traditional loan method is politically and economically much more feasible.

The most recent idea seriously discussed, is that savings be tapped directly by appropriate tax policy, and the spending program financed without the creation of debt, even of a fictitious character. The taxes proposed for the purpose are taxes which would be levied on personal income, estates, undistributed profits, and idle business funds. So-called incentive taxes are also proposed. Such schemes gain a good deal of support from the nature of the distribution of aggregate consumer savings by income levels. Heavy taxation of the incomes above $5,000 would do much to reduce aggregate personal savings.

Although a good deal might be accomplished by this multiple taxation attack, the advisability of centering a program around it seems highly questionable. A heavy reliance on such a program must assume either that private investment will not be discouraged or that what happens to private investment is a matter of little real consequence. Moreover, tax institutions have, and probably should have, a large element of stability. Congress cannot and should not manipulate income and sales taxes so as to produce wide fluctuations from year to year. A further examination of tax devices as instruments of fiscal policy will be found in the next main section.

However appealing we may find such daring suggestions, it is undeniably true that the present interest-paying debt is likely to show a continued rise during the coming decades. Even if we believe such a development to be sound, and incorporate it in our fiscal

[3] Mordecai Ezekiel, Statement before the Temporary National Economic Committee (separately bound), p. 6. (The first five of these approaches were proposed by Ezekiel in his testimony.)

philosophy, we must go on to provide something more than stop-gap debt and spending measures. The contention that "we cannot indefinitely and continuously add to the transfer obligations of our political system without jeopardizing political order" [4] is true—with qualifications. As Adolf Berle has said, "Use of the Federal credit by providing relief, and by taking care of certain necessary requirements in a limited field does keep the economic machinery of the country running; but it is not a permanent solution. There is always the danger that the time may come when an economy so organized will reach the end of its tether. We should be getting about the process of reorganization now, instead of leaving it for the more violent processes which always occur when the country is in great stress." [5]

It seems probable that a post-war investment program would result in a continuation of the growth of Government debt. Consequently, the nature of that debt—its mechanism of growth, its effect on the economic system—becomes of paramount importance.

2. THE NATURE AND FUNCTION OF DEBT

In his 1942 Budget message, President Roosevelt sized up the debt problem as follows: "I understand the concern of those who are disturbed by the growth of the Federal debt. Yet the main fiscal problem is not the rise of the debt, but the rise of debt charges in relation to the development of our resources."

The literature on public debt, both from the point of view of terminology and of concepts, is one of the backward areas of economic thinking. Any discussion of it must cut through a mass of truisms and poor symbols if it is to give us anything tangible to work with.

(a) *The function of public debt.*

Traditionally, Government borrowing has been considered a respectable method of financing exceptional expenditures in order to hold down to a minimum the disturbance of the tax structure.[6] Such a criterion was particularly appropriate when the expenditure was expected to be self-liquidating; but it also applied in case of war, devastation, or exceptionally heavy construction expenditure, when it seemed expedient to spread the tax cost over a period of years.

The fiscal philosophy of the post-war period must provide a place for such considerations, but an additional factor may be involved. Unless private investment can show a sustained recovery, public debt must be created for a fiscal purpose having little to do with disarrangement of the tax structure. The long-run necessity of assuring full employment, insofar as this can be done, is as valid a justification for public indebtedness as any consideration of tax equilibrium.

But it is a mistake to stop here. Justification of public debt, solely on the grounds of the fiscal necessity of making savings equal investment, is extremely dangerous—laying the Public Treasury wide open to pork-barrel raids and pressure-group irresponsibility. Debt incurred for war expenditure is, in every respect, an inalterable necessity; the same cannot be said for debt incurred for a fiscal purpose. Society still retains control over the direction of the expenditure.

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[4] Henry C. Simons, "Hansen on Fiscal Policy," The Journal of Political Economy, vol. 50, No. 2, April 1942, p. 174.

[5] Temporary National Economic Committee, Hearings, Savings and Investment, pt. 9, pp. 3810-3835.

[6] Lawrence Seltzer, "Direct versus Fiscal and Institutional Factors," American Economic Review, Papers and Proceedings, February 1941, p. 99.

(*b*) *The "creativeness" of public debt.*

Efforts have been made to measure the economic "creativeness" of the expenditure for which public debts are made—that is, the degree to which the expenditure makes easier the ultimate servicing and repayment of the debt. There is much confusion in the literature on this point, and the concept is significant enough to deserve amplification.

One very common classification runs as follows:

1. Dead-weight debt—debt incurred for expenditures which in no way increase the productive power of the community, yielding neither money revenue nor a future flow of benefits. War expenditures are usually taken as the prime example; sometimes relief expenditures are also included. This is a useful classification if it is remembered that war and relief expenditures are protective in nature—that is, they are designed to protect a past economic investment against the possibility of total loss or disorganization. In this sense they are "creative" of future values. A better word than "dead weight" might be "protective."

2. Passive debt—debt incurred for expenditures which, while yielding benefits to the community, do not return a money income. Parks and buildings are often given as examples of passive debt. Again the classification is a useful one, but not altogether satisfactory. Insofar as expenditures on parks increase health, they may indirectly produce a money return through greater earning power of the people.

3. Active debt—debt incurred for (*a*) capital expenditures on projects which are self-liquidating and (*b*) expenditures on projects which indirectly increase the productive power of the community.[7]

In theory, at least, the test of the creativeness of debt is clear. If expenditure directly improves the physical and human capital of the nation it is creative. It is both creative and self-liquidating in the broad sense if the improvement is such that the additional servicing and retirement charges, over the period of debt retirement, do not necessitate an increase in the ratio of tax collections to national income. (This goes beyond multiplier[8] considerations; it deals with direct increases in the quantity and quality of the factors of production.)

Society retains control over the direction of expenditure of debt incurred for fiscal purposes. This fact is of paramount importance, and, if the reefs of the future are to be avoided, we must be certain that debt incurred for the purpose of compensatory spending is highly creative. Two strands to the argument may now be added: (1) Public borrowing is expedient to finance crisis expenditures which otherwise would severely disarrange or strain the tax system; (2) fiscal policy may well demand continuous public borrowing in the post-war period; it is essential that this debt be incurred for highly creative investments.

(*c*) *Debt developments in the United States.*

In a very real sense the history of economic progress in the United States is the history of the growth of debt. New debts and new assets have usually been opposite sides of the same golden coin. There have been a number of recent developments in the debt field.

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[7] Ursula Hicks gives the classification of active, inactive, dead weight, on p. 284 of The Finance of British Government, 1920–1936, Oxford Press, London, 1938. The active-passive-dead-weight classification appears in Hansen's testimony—Temporary National Economic Committee, Hearings, Savings and Investment, pt. 9, p. 3810.

[8] A term used to describe the alleged tendency of public expenditure to augment business and employment beyond its immediate effect.

First, for the past 10 years government debt has been a growing proportion of total debt. But private debt in 1939 was still far below the volume of the twenties, and the growth of public debt never made up the difference. We must be prepared, in the post-war period, to initiate a public investment program much more substantial than the spending of the thirties.

Second, one of the most significant facts about the growth of nineteenth century debt is that large amounts of it were periodically liquidated; by frequent bloodlettings, wastes, and speculative excesses, obligations were written off the nation's debt burden. Our future debt structure is not likely to be of a character which permits similar processes to occur for two important reasons. First, a large part of it will be public debt, susceptible of write-off in case of complete breakdown of the economic system, or to partial write-off by inflationary price increases. Secondly, private investment has become such an interrelated process that large-scale liquidation is more perilous than ever before.

These factors place an extremely high premium on guaranteeing the creativeness of debt and on willingness to undertake any volume of public investment necessary for sustained high national-income levels.

The third important factor is that the public debt-making function seems to be shifting from lower to higher levels of government. (See table 43, p. 359.) The shift in relative rates of expansion began in 1932. Since that time State and local debt has actually decreased. Thus it seems possible that a Federal investment program will not only have to compensate for underinvestment in private industry, but, on occasion, for the inability of States and localities to continue normal debt-creating operations.[9]

Two views of the public debt have engaged public attention during the last decade. The institutional view is that large and mounting debt, unsupported by productive assets, is the sure road to bankruptcy. The fiscal view is that debt and debt creation may be a beneficent influence creating employment and enhancing national income. These two views should converge in a future public-investment program.

3. THE NATIONAL BUDGET AS AN EXPRESSION OF BASIC FISCAL AND SOCIAL PHILOSOPHY

(a) *The development of the Federal budget.*

"Budgetary principles were developed in a period when parliaments were struggling for control of administrations which tried to evade a democratic supervision of financial management." [10] As a result they were essentially negative in purpose—a limitation on government in the interest of economy and laissez-faire economics, rather than the

[9] Certainly there is no cause for immediate alarm. The Federal Government entered the present war in remarkably good financial shape. The Federal debt, by the fiscal year 1940, amounted to $43,000,000,000. Interest payments on this debt were at an average rate of about 2.5 percent, which meant annual payments of $1,100,000,000. Nine years before, the Federal debt totaled $16,800,000,000; average interest rates were 3.6 percent; thus making necessary payments of $611,000,000. Taxable income increased so substantially in the intervening period that the Nation may well be said to have entered this war with a less burdensome debt than that of 1931.

It would be difficult to predict what the end of the present war may leave in the way of Federal debt. Barring total catastrophe, there is no reason to believe that, if a farsighted and wealth-creating public investment program were initiated if and when it is needed to sustain national income at a high level, the demands of public debt cannot be met.

[10] Gerhard Colm, "Comments on Extraordinary Budgets," Social Research, May 1938, p. 168.

expression of a positive national purpose. Although a Federal budget was adopted late in our history, it was drawn up as an expression of these same principles of control and economy. Only in recent years has the national budget begun to evolve into something more positive.

Before 1921 the Federal Government cannot be said to have had a budget at all. To the Secretary of the Treasury was assigned the duty of preparing preliminary estimates of receipts and expenditures, but he seldom met this obligation by anything more than the forwarding of estimates by the spending officers of the Government.[11]

In June 1921, however, a campaign for budget reform culminated in the passage of the National Budget and Accounting Act, designed primarily to provide techniques for control and economy in the Federal fiscal system.[12]

Reform was introduced along four lines: (1) The duty of transmitting to Congress an annual budget statement of estimated revenue and expenditure was placed upon the President; (2) all other officers of the executive branch were forbidden to transmit such estimates except on special request by Congress; (3) a Bureau of the Budget was set up to aid the President in his budget function; (4) by a change in the rules of the House and the Senate all appropriations were concentrated in one committee in each House.[13]

Although this represented a step in the right direction, it left much to be desired. It gave no assurance that all expenditures and revenues would be embraced in the annual budget; deficiency and supplemental appropriations and large expenditures and receipts by specially constituted agencies continued to play a substantial role. The Bureau of the Budget was still considered to be little more than a Federal watchdog, and as a result the Budget expressed no over-all purposes nor positive program.

In the past 10 years, however, certain trends have begun:

1. Changes in the form of presentation of the Budget: Since 1930 there has been an intensification of the trend toward the development of a dual budget system, consisting of a general budget, which there is an obligation to balance, and various "special expenditures" for emergency and other purposes that may be met by borrowing. The development has not been an altogether clear and ordered one. Harvey Perloff makes the following comment:

> Through a dual bookkeeping arrangement—based on the principle of a balanced "regular" budget, which is made to balance by setting up a separate "emergency" category—the administration has kowtowed to the principle, avoided the fact. Furthermore, to escape the strait jacket of traditional federal finance, the government felt it necessary to create numerous independent agencies with power to obtain their own funds, and to indulge in all sorts of financial contortions. * * * It was impossible under such circumstances, for anyone, including Congress, to get a clear picture of what was going on.[14]

This movement seems to have culminated in the 1940 Budget message. The President suggested that different budgetary techniques should be used for the operating expenses of government and for "amounts disbursed for loans, or for self-liquidating projects, or for

[11] Richard Musgrave, "The Nature of Budgetary Balance and the Case for the Capital Budget," American Economic Review, June 1939, p. 283.

[12] See Harvey Perloff, "Budgetary Symbolism and Fiscal Planning," Public Policy, Harvard University Press, Cambridge, 1941, p. 41.

[13] This summary of the significant provisions of the act appears in Musgrave, op. cit., p. 283.

[14] Perloff, op. cit., p. 46.

other extraordinary capital outlays which increase the wealth of the Nation." [15]

As a step in this direction the message suggested that Congress might consider the advisability of placing a number of Federal agencies [16] on the same basis as the Commodity Credit Corporation, so that the Federal Budget would only be affected by annual surpluses or deficits resulting from their operations.

Faltering and confused though these developments are, they point toward the evolution of a loan or capital budget.

2. Changes in the concept of the function of the Budget: By the Reorganization Act of 1939 the Bureau of the Budget was placed in the Executive Office of the President. There is some indication that the shift was more than a formality—"through the reorganization, the emphasis of the work in the Bureau of the Budget has been shifted from the watchdog function into an instrument of management.[17]

The Bureau is now divided into five sections: Division of Estimates, Division of Legislative Reference, Division of Statistical Standards, Division of Administrative Management, the Fiscal Division.

Over-all budgetary problems are currently being examined in the Fiscal Division, and a new philosophy has gained some official expression. In an address before the American Accounting Association, an Assistant Director of the Budget concluded his remarks as follows:

> In closing I venture to lapse again into the philosophical, to peep into the future. I ask you to think of budget execution in perhaps a new sense. It is budget control at the national level. It is the execution of the national program which envisions the economic and social implications of the budget for the economy as a whole. Legislation must obviously provide the framework for a flexible fiscal policy. * * * Congress may appropriate for what has been called developmental programs extending through a period of years, but leaving the timing of actual expenditures to the Executive, within the framework of the law.[18]

Of equal significance for future budgetary developments were three short sentences of the President's message for the fiscal year 1942: "The Budget of the United States presents our national program. It is a preview of our work plan, a forecast of things to come. It charts the course of the Nation." [19]

A new and positive note has been struck. A new budgetary philosophy is stirring. The experience of other nations may afford some light for future guidance.

(*b*) *The Swedish and Danish experience.*

"The incredible fact to be noted by Americans of every stripe is that Sweden has gone in for a far-reaching New Dealism without scaring, overtaxing, or otherwise discouraging private enterprise and investments." [20] In these high terms of praise has the fiscal program of one of our neighbors been described.

[15] The Budget of the United States Government, for the Fiscal Year Ending June 30, 1940, 1939, p. IX.

[16] The agencies suggested were: Agencies under Farm Credit Administration, Electric Home and Farm Authority, Export-Import Bank of Washington, Farm Security Administration, Federal Crop Insurance Corporation, Federal Savings and Loan Insurance Corporation, Home Owners' Loan Corporation, Inland Waterways Corporation, Panama Railroad, Reconstruction Finance Corporation, Rural Electrification Administration, United States Maritime Commission.

[17] J. Weldon Jones, The Execution of the Federal Budget, address given at the twenty-sixth annual meeting of the American Accounting Association, New York City, December 30, 1941, p. 2.

[18] Ibid, pp. 13-14.

[19] The Budget of the United States Government for the Fiscal Year Ending June 30, 1942, 1941, p. XIV.

[20] "That Wonderful Swedish Budget," Fortune, September 1938, p. 65.

The depression hit Sweden early and hard, and by 1930 a drastic deflation had been carried out. This was, undoubtedly, the initiating cause of recovery. It stimulated an export trade that was already beginning to supply the armament needs of Europe. But after an initial period of a year, during which the spending program bogged down owing to lack of foresight and planning, a new technique of fiscal policy was followed by recovery in the home industries, so that by 1938 industrial production was 50 percent above the 1929 peak, and the Government was able to begin repayment of the recently acquired debt.[21]

The new budget technique was largely perfected between 1933 and 1937. In a recent article Gunnar Myrdal has outlined its fundamentals:[22]

1. Basic to the whole system is the principle that soundness of public finance depends on the preservation intact of the net value of the state's income-earning assets, over and above national debt.

2. With certain exceptions, it is laid down as a principle that only profitable, self-liquidating investments can ordinarily be financed out of loans. (Under this heading have been included railroads, power plants, public utilities, etc.)

3. Certain other expenditures have been classified as "self-liquidating," thus making them available for loan-investment purposes. For example, a public corporation was instituted to own and administer the state's public buildings, schools, post offices, and hospitals. Each administrative branch is then required to pay to this corporation yearly rent for the use of its quarters to cover upkeep, and interest and depreciation charges.

4. Provision is made for two budgets. The operating budget is to be balanced over the trade-cycle period—the traditional policy being to charge all expenditures for "unproductive" or "ordinary" purposes to it, to be paid for as completely as possible out of current taxes. In order to guarantee cyclical monetary balance of this budget, the deficit of 1 year is charged against the following years at the minimum rate of 20 percent annually until the debt is wiped out.[23] Expenditure for self-liquidating works are charged to the capital budget; depreciation entries are annually made on the operating budget and provided for by taxation or by direct money returns from the capital works.[24] The capital budget is thus set up along the lines of a revolving fund, but reflects a gradual growth of state assets.

Several points should be kept in mind for a clear understanding of the Swedish technique.

1. There is basic agreement on the desirability of two things, (a) the gradual increase of the state's assets and (b) the encouragement of private industry to develop other sectors of the economy.[25] As Hansen has pointed out, the system "grew naturally out of the fact that the Swedish state had for many decades past owned important state enterprises."[26] (Railroads, bus lines, telegraph and tele-

[21] Ibid., pp. 65, 136.
[22] Gunnar Myrdal, "Fiscal Policy in the Business Cycle," American Economic Review, Supplement, March 1939, pp. 183-193.
[23] "That Wonderful Swedish Budget," op. cit., p. 148.
[24] For a discussion of the technique employed see Spencer Thompson, "The Investment Budget," Public Policy, 1941. pp. 69–70.
[25] Eric Lindahl, Studies in the Theory of Money and Capital, Allen and Unwin, London, 1939, p. 356.
[26] Temporary National Economic Committee, Hearings, Savings and Investment, Pt. 9, pp. 3847-3848.

phone systems, large electric power plants, iron-ore reserves and forests; and such factories and other improvements as are closely related to the operation of these projects.) There is general acceptance of this dual economy in Sweden, and efforts are made to encourage private enterprise by favorable tax policy, and by the promotion of clear understanding of fiscal policy and of the predictability of government action.

2. The system provides a means of combating the trade cycle and was largely designed for this purpose. However, it also provides a method of dealing with secular problems of "economic maturity."

3. Fundamental to the system is the careful planning of long-range public investments, which, it is hoped, will eliminate the waste and confusion that characterized the program during its initial operations. Such planning not only applies to activities of the central government and the state-owned activities, but also to local government investments.[27] The rate at which the investments are made depends very largely on cyclical and secular considerations.

The Danish budget is quite as interesting, for American purposes, as the Swedish. The system was inaugurated in 1937 and makes durability, not revenue production, the criterion for inclusion in the investment budget.

> Any outlay which creates a material asset of a durability extending beyond one year belongs to the capital budget. This heading comprises not only investments in public enterprises, the acquisition of shares in semipublic or private undertakings and the granting of loans, but also non-self-liquidating expenditures such as the building of schools, hospitals, administrative offices, etc.[28]

Expenditures falling under these headings are financed in three ways—by inheritance taxes, amortization and depreciation allowances, and borrowing. Funds are accumulated, over the lifetime of the investment project, either from the direct monetary return of operations or from taxation, to replace the works or retire the debt. The technique employed is the charging of depreciation and interest allowances to the operating budget at rates in accordance with the length of life of the public investment assets.

(c) *The issues involved in the investment budget.*

Some of the issues involved in the use of Swedish and Danish technique may now be considered:

1. Presenting a clear picture of financial operations: As Hansen points out, an essential purpose of any budgetary statement is "to obtain a clear conception of the financial operations of an economic unit." [29] Our present budget statement does not meet the above criterion. A well-designed double-budget system should, if it is properly used, provide the much-needed clarity.

2. Expressing a social purpose and maximizing efficiency in carrying out that purpose: The Federal Budget should express the clear-cut determination of a democratic people to accomplish well-defined social purposes in carefully planned and delineated fields.

The investment side of a dual budget not only provides a framework for the expression of such purposiveness, but also the framework for discipline and strict accounting, to make certain that the will of the people is being carried out without waste, inefficiency, and political

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[27] Lindahl, op. cit., p. 348.
[28] Brinley Thomas, Monetary Policy and Crises, Routledge, London, 1936, p. 126.
[29] Alvin H. Hansen, Fiscal Policy and Business Cycles, Norton, New York, 1941, p. 186.

nepotism. As an aid in determining the appropriate direction of public expenditures and the degree of efficiency achieved, the investment budget is an invaluable technique.

3. Implementing the attack on cyclical and secular problems: The dual budget, properly used, should contribute to public understanding of the value of a public-works program as a device for reducing unemployment. Thus it should contribute to business confidence.

The requisite spending may, at times, be very heavy. Fiscally, what is required is not stimulus but compensatory action substantial enough never to permit of great recession of national income levels. The price of halfway measures is too severe to be tolerated. In retrospect, we see that that price was paid during the thirties with a loss of potential goods and services that may have amounted to $200,000,000,000.

If coupled with a strict policy of spending for creative assets and a fiscal determination to resist to the limit all curtailment of economic power, the investment budget will provide the controls and expenditure technique without which spending for a purely fiscal purpose would be, in the end, self-defeating.

4. Criteria for placing items on the investment budget and the principles to be observed in writing them off. There are a number of possibilities:

(*a*) Only physically durable items would be placed on the budget and written off as fast as they depreciate. No attention would be paid to self-liquidating considerations.

(*b*) Only income-yielding projects would be placed on the investment budget, and the loans retired as the income comes in. This might apply both to durable assets and to services.

(*c*) Income-yielding and economically creative projects (services or construction) would be placed on the investment budget and written off at different appropriate rates depending, for the first, on the income received, and for the second, on durability or the longevity of the creative effects of the original expenditures.

On balance it would seem that items placed on the capital budget should be amortized according to the following principles: First, for all construction projects the amortization period should be the life of the project. The investment budget would be debited with the initial outlay and a loan and/or grant would be extended to a Federal, State, or local agency. Over the selected period the outlay would be amortized and paid for by charges and State, local, and Federal taxes. Second, for all service investments amortization would take place in the same manner, except that the period chosen would depend on the degree of permanence of the effects of the investment. For example, a 5-year health service program might be expected to have effects lasting for at least one generation and accordingly charged off at an appropriate rate, say 4 percent per annum.

The rate of growth or decline of the total public investment should depend primarily on over-all economic developments, both cyclical and secular. It must be realized that, in all probability, a closed investment circle will exist only for short periods of time; individual items will be completely liquidated, but the total public investment may be expected to show a continuous rise.

The program contemplates that total public debt will rise at the same time that national income is rising. Not only will the multiplier principle be operating, but by direct expenditure to increase the quantity and quality of the factors of production, heavier private investment will be constantly encouraged.

Adequate public investment is sure to require a very considerable amount of intelligent advance planning. Many Federal agencies, private agencies, and industrial organizations are already active in the field. Most of the over-all research has, however, just begun and is in a nebulous, indefinite state. The National Resources Planning Board and the Public Works Reserve are developing a substantial list of desirable projects, but, owing to lack of funds for specific engineering planning and surveying, may end up by assembling little more than a national hope chest. Most discouraging of all, Congress has shown little sympathy for post-war planning activities, and has recently curtailed appropriations for such purposes.

But the picture is not altogether dark. A beginning has been made in coming to grips with the basic problems, and new techniques of intergovernmental cooperation have been developed, at least at the planning stage, and promise much for the future. Outstanding examples of the new method are the techniques used by the National Resources Planning Board, the Public Works Reserve, the Bureau of Agricultural Economics, and the United States Housing Authority. In each case, at the initiative of the Federal Government, States or localities have set up semi-independent agencies or new departments to cooperate with Federal authorities on some aspect of the planning endeavor. If these cooperative arrangements prove successful, localities may expect to play a very substantial role in the post-war investment program; if not, it seems likely that more direct technique will be employed.

4. THE IMPLEMENTATION DEVICES

It is extremely difficult to evaluate the implementation devices by which the cooperative efforts of all levels of government might be brought to bear upon the post-war public investment program. The general outline of what cooperative relationships and devices should be employed is reasonably clear, but the field is such a new one and in such a state of flux that, in many specific cases, the desirable pattern is not yet determinable.

(a) *The government corporation.*

There is much to be said for using the government corporate device as a channel for funds flowing from the investment budget to the Federal, State, and local spending agencies. A Federal investment corporation might be set up for each major investment field—to carry out the loan and grant function, enforce what Federal standards seem desirable, and receive payments for amortization purposes from the various levels of government to be credited to the capital budget.

(b) *The role of the various levels of government.*

No far-reaching reallocation of the functions of government has been contemplated in this report. The belief that a fundamental reallocation of functions is not necessary for post-war investment purposes is, however, based on an important assumption—the revitalization of present State and local governmental units.

It will probably seem desirable to carry out some of the post-war investment projects by direct Federal action; river valley projects, nutrition, and some aspects of rural rehabilitation and conservation seem to fall under this category.

The major part of the investment program, however, should probably be executed by States and particularly localities. If it is to be effectively done, they must have adequate powers and efficient administration. For some purposes (urban rehabilitation and low-cost housing) an extended urban government, either coterminous with a county or including parts of several counties, seems most desirable. For others, a revitalized rural county seems most appropriate; and finally in certain fields, such as highways and some aspects of conservation and rural rehabilitation, the States or even well-designed regions look most promising.

(c) *The loan-grant.*

The major part of the investment program should be carried out by what might be called the loan-grant technique. Three general cases might be contemplated.

(1) In certain situations it might be desirable for all of cost of the project to be met by a loan from the investment corporation to a Federal, State, or local agency. This method should be used when the project may reasonably be expected over its life period to yield a return within the jurisdiction of the sponsoring agency, by charges or by increased tax returns equal to the loan. Although such loans will undoubtedly be an element in most of the investments, frequent use of loans exclusively would not be expected.

(2) At the opposite extreme there might be cases where a straight grant to an agency of government would be desirable. It would be used in cases where the effect of the expenditure was so general as to be incapable of recapture by charges or taxation within the sponsoring jurisdiction. Over the amortization period of the project the grant from the capital budget would be written off by appropriations from current Federal tax revenue. It is expected that Federal revenues will be increased by such expenditures, although indirectly. As in the case of the exclusive loan technique, the exclusive grant technique would seldom be desirable.

(3) In most cases some combination of the two would be used—the loan for that part of the expenditure that is expected to be captured from the territorial jurisdiction of the sponsor, and the grant for that part to which increased Federal tax revenues are assignable.

It should be pointed out that such techniques as are chosen can be used for Federal agencies as well as for those of States and localities. The only difference lies in the lack of taxing power of, say, a Federal regional authority. The loan will still have application for three contingencies: first, when the regional development agency contemplates loans to local governments within the region; second, when direct charges can be made; third, when the regional authority can justifiably recapture special benefits to the area by requiring payments from States and local agencies out of increased revenues.

There are two other factors which should be weighed in fixing loan and grant proportions, (1) the national interest in increasing the economic ability of the area in which the project is operating, and (2) the importance of minimum social standards. These two factors will tend to weight the balance in favor of the grant for backward economic areas that are a drag on the economy as a whole and for functions such as health where a national minimum is both feasible and highly desirable.

The closely associated problem of apportionment of funds to projects in different sections of the country is difficult of solution. However, the apportionment should be largely determined by the economic and social gains offered by the different projects. Since such gains will tend to be greatest in the relatively unexploited or economically maladjusted areas the program will include an element of equalization.

5. THE FIELDS FOR INVESTMENT

Clearly delineated fields of expenditure should be selected which promise most in the way of creative opportunity for public investment—that is, in laying the groundwork for greater private investment and progressively higher national incomes. In such fields vested interests must give way to public purposes in order to assure maximum effectiveness of expenditure. There is good reason to believe that urban rehabilitation and low-cost housing, health, nutrition, regional development, and rural conservation and land-use rationalization are among the most promising fields. While the investment possibilities and problems in these fields cannot be discussed here in detail, a few high lights are indicated in the following pages.

(a) *Urban rehabilitation and low-cost housing.*

1. The investment field. Owing to the interrelated nature of the problems involved it seems advisable to treat the urban low-cost housing field as but one facet of the problem of urban redevelopment and revitalization. The core of the problem lies in $40,000,000,000 worth of slum and blighted land, the ceaseless growth of which threatens our cities with disorganization and bankruptcy. The low-cost housing problem, per se, consists of constructing dwellings for families with incomes under $1,500, a level of income which seems beyond the reach of the private construction industry.

2. Major problems of implementation. The most serious hurdle in implementing the investment program is that of extending municipal control over the use of land. Not only must the cities have adequate zoning powers, but they must have the right to condemn land in large blocks for future multiple-purpose uses and complete freedom in determining that future use. In addition, taxing jurisdiction and planning control must be extended over suburban areas.

Of almost equal importance are the problems of reducing land, labor, interest, and material costs for low-income housing. Finally, the necessity for large-scale, detailed planning cannot be stressed too much as a requisite for any substantial program in this housing and redevelopment field.

3. A possible program. The urban governmental unit, with greatly extended territorial and planning powers, should probably serve as the fundamental agency of the program. Some Federal agency should extend loans to such localities to purchase from one-third to one-half of their slum and blighted areas. Grants would be extended by the same agency for low-cost housing and other development projects. Over the amortization period the investment would be liquidated out of local charges for rent of housing projects and use of land, local taxes, and Federal taxes. In addition, tax loans would

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probably have to be extended to see the cities through the transition period.

At the end of a 20-year program we would expect to see a reduction of private and public charges for health, sanitation, crime, and fire, more adequate and cheaper transportation and terminal facilities, and expanded private-investment opportunities, owing to a healthier, more contented labor force, a more rational local tax structure, and better land-use patterns.

(*b*) *Health and nutrition.*

1. The investment field: Our total health bill—costs of medical care and health services, loss of wages because of sickness, and loss of earning power because of premature death—has been calculated to run as high as $10,000,000,000 annually.[30] That an adequate investment in health and nutrition can very substantially reduce the cost due to ill health and vastly increase the productive powers of the nation seems a certainty. There is great need of 180,000 new general hospital beds, 50,000 new beds for tuberculosis patients, and 130,000 new beds for the mentally ill. It would pay the Nation to double its investment in State health departments, professional health services for counties and cities, and diagnostic centers for remote rural areas. First-rate investment opportunities lie in a thoroughgoing attack on tuberculosis, pneumonia, cancer, malaria, death at childbirth, malnutrition, and many other health problems.

2. Major problems of implementation: A major difficulty in planning for Federal health and nutrition investment is that of determining the different roles of the levels of government. Most discussion of such problems has envisaged Federal aid extended to the States within the framework of the Social Security Act, and then passed on to urban and rural health units. Since 1935 Federal nutrition work has been carried out through a variety of contacts with State and local agencies and relief families. Recently, however, planning has been undertaken by newly established State and county semi-independent committees.

3. A possible program: Loans and grants for the health investment could be extended to States and localities by some Federal agency. Urban government and county health agencies would be taken as the fundamental governmental agencies for the program, with State health agencies acting as advisory and coordinating bodies. Although limited funds might be collected from charges, the loans and grants would be very largely amortized out of local, State and Federal taxes.

A multiple direct-action program of nutritional investment might be carried out by a Federal corporation. The program could place major reliance on food-stamp plans, other special-commodity consumer-subsidy schemes, educational campaigns, and encouragement of further research. Loans from the investment budget to the corporation would be amortized over a period of 25 years, almost entirely out of Federal taxation.

(*c*) *Regional development programs.*

1. The investment field: Quite a number of investment projects are subject to a multiple-purpose regional investment approach. The technique is useful when there is a central problem or project, the ramifications of which are wide enough to demand coordinate treat-

[30] Subcommittee of Senate Committee on Education and Labor, Hearings on S. 1620, 76th Cong., 1st sess., pp. 21-22.

ment over a substantial territory. Thus far the most promising plans have been drawn up for river-valley programs, centering about power or irrigation projects, but there is no reason to believe that the same technique would not be applicable to cut-over regions, Dust Bowl problems, interstate metropolitan regions, etc.

Tennessee Valley Authority experience has given us much evidence of the creativeness of such an investment. The multiple-purpose nature of the program makes a coordinate development of the factors of production possible, thus assuring their availability for private investment.

2. Major problems of implementation: Regional organizations can be set up by congressional enactments, by interstate compacts, and by informal understandings among States. Thus far the most success has been had with the first of these alternatives. It seems probable that the informal agreement is chiefly useful for general planning purposes, to lay a base for the other two techniques.

As employed by the Tennessee Valley Authority the regional approach has called forth a surprising amount of effective intergovernmental cooperation, without which success could not have been so much as hoped for.

3. A possible program: The Tennessee Valley Authority technique might well be extended to other predominantly rural regions of the nation where multiple-purpose development promises high investment returns. Loans would be extended from the investment budget to regional development corporations and would be amortized from charges, grants from States and localities to the Corporation, loan repayments from States and localities, and Federal taxes. There is reason to believe that the region should be made to bear a substantial part of the cost, since a major part of the benefits will fall within its boundaries.

In some problems involving rural areas and in most cases involving interstate metropolitan districts the interstate compact with Federal participation might be made an effective technique. A regional authority with real powers would have to be set up, which would then deal with the States and the Federal Government in carrying out the investment.

(*d*) *Rural development and conservation investments.*

There are extremely promising investment opportunities in rural America, not only in forest improvements, drainage and water-control measures, soil erosion, and irrigation projects, but in rural health, housing, and electrification.

The major difficulty lies in carrying out such a program along lines compatible with the shifts that are necessary in our agricultural economy. The post-war investment in rural America should be guided by two general principles. The first is that the agricultural problem cannot be solved by agricultural measures alone; a gradual readjustment of farming populations and the shifting of rural people to industrial and commercial pursuits may well prove necessary. Secondly, conservation of our resources and extensive changes in land-use patterns are fundamental to any nation-wide approach to rural problems.

Thus it seems essential to conduct the over-all rural-investment program in close connection with, and subordinate to, direct Federal-action programs which are designed to strike at fundamental disequilibria. The usefulness of the State as a territorial administrative unit seems much greater in this than any of the other investment fields thus far examined.

The planning for agriculture now being undertaken by the land-use planning committees is one of the most promising developments for the American post-war scene. Out of it may spring the kind of coordinated attack within which a Federal rural investment program will prove most effective.

(*e*) *Education and highways.*

Although it must be recognized that there are valid fiscal and equalization reasons for heavy Federal expenditures for education and highways in the post-war period, it seems wise to place but a part of that expenditure on the investment budget.

In the case of education, certain extremely backward educational areas of the nation, chiefly in rural sections, represent, owing to migration of population, national infection centers of such seriousness that outright investments seem justifiable. The grant-in-aid technique should be used in such cases, thus relying mainly on the States to bring about internal equalization and school-district reforms.

There is a reasonably good case for including an interregional highway system as an item on the investment budget. Again the grant-in-aid technique would be used, and the State highway commissions would be relied upon as basic operating units. The Bureau of Public Roads has drawn up plans for such a system comprising some 26,700 miles of roads.

Finally, educational and highway investment opportunities will undoubtedly arise in connection with other investment programs. Of particular importance in this connection would be urban rehabilitation programs, regional development programs, and rural land-use and conservation programs.

Local governments, like individuals, will have a considerable inventory of deferred construction needs after the war. But they may not have the financial capacity to meet these needs. They can to some extent insure this capacity by paying off debts and building reserves during the war. Possible Federal encouragement of this policy will be discussed later.

The details of any public investment program are not easy to manage and require much political discipline—perhaps more than can be expected. There is some truth in the view that a public investment program promises "a promiscuous spreading of governmental activities which * * * gets the Government involved in a mass of miscellaneous undertakings for which it has little competence, and impairs and inhibits enterprise in many areas where competitive control is most appropriate." [31] But alternatives, such as a perpetually mounting unsecured public debt, and the issuance of non-interest-bearing obligations, involve even greater problems and certainly a far greater departure from past traditions than the program here recommended. Of course if no program at all is necessary, so much the better. But the situation is not reassuring, and we must be ready. There will be vested interests that would prefer to see public money spent in lines that are strictly "noncompetitive." These vested interests must be either dissuaded or pushed aside. It is partly to retain a large part of our traditional private economy

[31] Henry C. Simons, "Hansen on Fiscal Policy," op. cit., p. 173.

that plans like the above are proposed, and they should have the united support of those who are interested in preserving traditional values and sane and orderly progress.

E. Fiscal Policy and the Tax System

Assuming the validity of the stagnation thesis which contemplates a chronic condition of underconsumption or oversaving, what might be done to adapt the tax system to combat this condition?

1. REGRESSIVITY OF THE TAX SYSTEM

A principal criticism of the over-all tax system is that it is alleged to be regressive, falling with greater weight on the lower brackets of income than on higher brackets. This criticism applies mainly to the income classes to which the Federal income tax does not apply. Until recently this has been much the largest part of the population, but lowering of exemptions with the war will probably bring the majority of the population within the range of the progressive tax system. The incidence of an entire tax system, because of its large number of specific taxes and because of the obscurity that surrounds the whole subject of incidence, is quite difficult to determine at all and especially difficult to determine authoritatively. At least two major attempts have been made to arrive at an answer. The first was made by the Twentieth Century Fund.[32] Several assumptions regarding shifting and capitalization were employed and the taxpayer was presumed alternatively to be a resident of New York and of Illinois. The evidence showed some regressivity in the tax system for incomes below the level of the Federal income tax, which included the overwhelming majority of the taxpayers. Above the low brackets within the income tax range, progression was quite discernible. Somewhat the same picture was presented in the other study, a Temporary National Economic Committee project by Gerhard Colm and Helen Tarasov.[33] This showed a tendency toward regressivity in the income groups below $3,000 and only in the $10,000 to $15,000 range were taxes found to exceed in percentage of income those paid by the lowest bracket with incomes under $500. Certain procedures used by the authors, such as ignoring the capitalization of property taxes, might be criticized, and different assumptions might have altered the result to some degree in favor of less regressivity. But that there is an element of regressivity in the lower brackets of the tax system, resulting from heavy reliance on consumption and property taxes, probably the great majority of students of the tax system would agree. The range of incomes subject to regressive taxes has been reduced markedly, however, with the reduction of exemptions for the Federal income tax.

2. RELATION OF FEDERAL TO STATE AND LOCAL TAX STRUCTURES

The regressivity of the tax system is a matter of concern, not only because of the inequity involved, but also because of the bad economic effects that may follow. Even a progressive tax system may be

[32] Facing the Tax Problem, Twentieth Century Fund, New York, 1937, p. 237.
[33] Gerhard Colm and Helen Tarasov, "Who Pays the Taxes?" Monograph No. 3, Temporary National Economic Committee, 1940.

criticized on these grounds if the degree of progressivity is relatively slight. The prevailing view of the thirties was that the economic system suffers from underconsumption and oversavings. If this diagnosis was correct, and if the future is to show the same tendencies as the past, then the tax system as such can be judged an aggravation of the problem. Of course, the Federal Government could balance the fiscal system by its spending program, but the job would be made more difficult by the maldistribution of the tax load. Looking to the future, there are those who say that the tax system should be made definitely progressive throughout, and they add that, with this objective in mind, the Federal Government had better assume a larger share of the tax-collecting function, distributing what the States and local governments require from the central treasury. Several observations concerning this program seem in order:

The Federal system in 1938 as analyzed by Colm and Tarasov was apparently only a little less regressive in the low-income brackets than the State and local systems. Substantial changes, mostly in the direction of more progressivity, have occurred since 1938. If it is in the national interest to give the ability-to-pay taxes a much larger place in the revenue picture, the Federal Government can do so by putting its own house in order before undertaking to carry the tax load of the States and their subdivisions.

The restricting factors in the use of the income tax—political, administrative, and economic—are limitations on the amount of revenues that can be collected from this source. The Federal Government with its deficits, its State-aid programs, and its regressive taxes, will hardly be limited in its efforts at tax reform by lack of need for the proceeds.

The Federal Government's share in total tax collections increased from 27.1 percent in 1915 to 33.8 percent in 1930 and to 45.7 percent in 1941 (table 31, p. 333 and chart 3, p. 334). The war will increase this proportion. After the war, there may be a return to more normal proportions, but the upward trend in relative Federal position probably will and should continue. Moreover, taxes do not tell the whole story. The Federal Government used its fiscal power of credit during the thirties, not only to finance its own program, but also to aid the States. In 1936, over half of governmental expenditures were accounted for by the Federal Government, and this was true again in 1941, when the proportion was 56.3 percent [34] (table 41, p. 358).

Nevertheless, our Federal Government remains conspicuous among the countries of the world in the relatively small place it occupies in total public revenues. It is argued, too, that the State and local governments tend to defeat the countercycle fiscal program of the Federal Government by their borrowing policy. The problem, as visualized during the thirties, has been well stated as follows:

> Unfortunately, the recovery efforts of the Federal Government have been largely nullified by efforts in the opposite direction on the part of States and localities. During the 7 years ending in 1930 the net long-term borrowings of State and local governments, after allowance is made for refunding and retirements, averaged very close to a billion dollars per annum. These borrowings were spent for the most part on permanent capital improvements, became income to some one, and helped swell the stream of current purchasing power. In 1932, borrowings of the States and municipalities for purposes other than refunding dropped to about $200,000,000. In 1933, net borrowings disappeared altogether, the volume of

[34] Including grants to States as Federal expenditure.

bonds retired exceeding the volume of new issues. This is, of course, only part of the story of deflation as practiced by State and local governments during the current depression. State and local budgets have been everywhere cruelly slashed. Educational expenditures were reduced by half a billion dollars between 1930 and 1934. School expenditures per child enrolled declined from a national average of $90 in 1930 to $67 in 1934.

Had the State and local governments adapted their fiscal policies to the requirements of recovery, they would have refrained as far as possible from levying new taxes or increasing the rates of old ones. To the extent that new taxes were unavoidable, they would have selected such taxes as were likely to trench on savings rather than on necessary consumption. Actually, as we know, the outstanding fiscal invention of the depression period was the sales tax.[35]

The above indictment is at least a substantial argument for an expansion of the Federal grant-in-aid system. However, it should be said in the interest of local fiscal independence that municipalities, like the Federal Government, are much more conscious of the need for cyclical planning of public works than formerly. Federal grants with local sponsors' contributions are a means by which local construction programs can be made to conform in larger measure to the exigencies of the business cycle.

3. TAXATION AND BUSINESS INCENTIVES

A criticism of the over-all tax system which seems to a large extent to run directly counter to some of those discussed above is the contention that the system is repressive.[36] The maintenance of purchasing power is a function of private investment as well as of the distribution of income. Heavy taxes on corporations, corporation profits, and large individual incomes tend to dull the incentive to enterprise and risk taking. During the thirties, when concessions were being made to the consumer, the investor went on more or less of a strike. It is alleged that high surtaxes, which cut down the possible yield on risky investments, particularly on the marginal dollars of income, make safe disposition of funds more desirable. The relative attractiveness of alternative investments has been substantially modified by the tax system.

That there is a great deal of validity in this analysis can hardly be denied. The very pessimistic tone of the stock market is probably to some extent a reflection of anticipated tax burdens. Of course this is not the sole explanation. Confidence in the future is at low ebb for many reasons, among them doubts about the future of consumer demand, the future of international relations, and the stability of the economic system itself. Reducing surtaxes would not do much to counteract most of these causes of diffidence, and it might positively encourage some of them. It is noteworthy that the stock market has failed to respond much even to very high profits after taxes, which have characterized some businesses and individuals during the war period. Moreover, as has been explained, there are important ways of promoting confidence, other than adjusting the tax system.

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[35] Clarence Heer, "Coordination of American Federal, State, and Local Finance," in Paul Studenski, Taxation and Public Policy, Smith, New York, 1936, p. 134.

[36] An objection commonly raised against the over-all tax system is that the general property tax—often referred to as an outworn tax—has to carry one-third, formerly one-half, of the burden. Some discussion of the property tax situation will follow in a later section. While taxing general property, particularly real estate, is probably not the best way to raise revenue, it is by no means the worst. No country in modern times has been able to raise all the revenue required for governments from income taxes. On the other hand, it must be recognized that the elasticity of the property tax is no longer very great. The public will, in most cases, tolerate present burdens on property, but it has shown a disposition to resist increases. As later suggested the general property tax as an independent source of local revenue is due for a thorough overhauling.

To a very considerable extent, however, the interest in favoring consumption as against savings is in conflict with the interest in promoting confidence. Nevertheless, the tax system might be modified in several respects in the interest of greater support for risk-taking without undermining its use to support other economic objectives. One is to include interest on all Government securities, much of which is now tax-exempt, in the income-tax base. This discrimination in favor of the safest form of investment is undesirable not only in its economic effects but also because it undermines the attempt to measure a personal tax on all income received by the citizen. Further relief for equity financing could be achieved by a partial credit against corporate income for dividends paid out. The application of the corporation tax to the net operating income of the corporation rather than the net income might also be considered. The proposal means in effect that interest paid (and perhaps rent paid out) would be disallowed as deductions in calculating the base of the corporation tax. At present the tax system gives an incentive to load corporate financial structure with bonds, since this form of financing reduces the potential corporate tax base. The proposal involves many problems of policy as well as practical application. Certainly it would have to be introduced gradually and with concessions for existing contractual arrangements. The sharp difference between the bondholder and stockholder, particularly certain classes of each category, has become blurred under modern conditions of large scale corporate business, and the changing nature of the corporate institution might be given weight in corporate tax policy. Considerations of incidence and economic effects can be offered against the proposal. On the whole the dividend credit appears to be a more desirable alternative. A more orderly, logical, and "deemphasized" system of business taxation should also help to mitigate tax repressiveness. All these proposals will be discussed in more detail later.

It should be observed, too, that not all taxes which reduce inequalities of wealth and income have equal weight in their repressive effects on investment and business incentives. Probably the taxes could be ranked according to their repressive effects (first rank to those with most such effects) as follows: Excess-profits tax, corporate net income tax, personal net income tax, estate and gift taxes. There is some validity in the view that entrepreneurs are affected less as to incentive by taxes which reach them after their succcess has been achieved than by taxes which limit their achievement. It is submitted that in the choice of war and post-war taxes some attention should be paid to the above ranking. Particularly, it seems in order to put less stress on business taxes and more on personal taxes.

In the development of personal taxation it is possible to put more stress on the closing of loopholes and less on maximum rates of tax. Loopholes in both the personal net income tax and the death taxes have been notorious. As to the first, tax-exempt income and undistributed corporation profits are the most conspicuous. The first should be eliminated and the second should be subject to some special treatment which would eliminate or reduce the high discrimination against distributed profits.

Professor Hansen recently proposed a direct attack on the propensity of the tax system to discourage private investment.[37] He

[37] Alvin Hansen and Guy Greer, "Federal Taxes and the Future," Harpers, vol. 184, April 1942, pp. 498-499.

proposed to exempt new investment from the income tax. Under this proposal the income tax would apply to income received and invested in old investment but new investment would be "subsidized" by the tax system. The proposal is an attractive one but exceedingly difficult to implement. Much individual saving goes into new investment indirectly through banks and insurance companies and other financial institutions. It would be difficult to trace the taxpayer's savings through these institutions and even worse to ignore the fact that these savings may ultimately be used for new investment. The dollar that is invested in old investment, thus freeing another dollar for new investment, is hardly less socially useful than the dollar that goes into new investment directly. On the whole the proposal seems of doubtful feasibility. If the proposal were confined to corporations it might be simpler and easier to justify. But this sounds much like the differential advantage in favor of undistributed income which has been so objectionable on equitable grounds. However, if some credit were to be allowed on the corporation tax base for income distributed and thus subject to individual surtaxes, the credit might be extended to cover a certain amount of income (possibly 10 percent) whether or not distributed. This would be on the theory that business is subject to a certain amount of concealed obsolescence but it would also tend to favor new investment. Lower income taxes would support incentives directly but this solution is objected to because of its effect on the distribution of income which in turn has a bearing on investment from the consumers' demand side of the problem.

In recent years there have been many other proposals for so-called incentive taxation, most of them aimed at full production by the imposition of penalties on idleness and hoarding. Taxes are to be taken off production and imposed upon nonproduction. Whether taxation could be used successfully as a spur to economic activity in this way is, however, quite doubtful. In a free economic order the old adage that "you can lead a horse to water but you cannot make him drink" would appear applicable. In the case of pay-roll taxes, differentials according to the success with which employers combat irregular employment may prove useful. Even this runs in some degree counter to the so-called insurance objectives of unemployment compensation and pay-roll taxes. In any event it remains true that concern for incentives must remain a major interest and limiting factor in the choice of a tax system.

The problem of repressiveness in the tax system does not in any great degree involve intergovernmental relations. It can be plausibly argued that State taxation of business is repressive. Probably the repressive effects, if any, arise mostly from the confusion of State business taxes and excessive cost of compliance, particularly for interstate business, with multitudinous State statutes. State trade barriers are repressive to interstate commerce. Something can and should be done about these repressive features, and certain proposed remedies for them are discussed elsewhere.

CHAPTER VI

MISCELLANEOUS PROBLEMS

A. Public Debt and Intergovernmental Relations

1. INTRODUCTION

Public debt is an important factor both in the fiscal-policy and institutional problems of public finance. Up to 1933 the institutional problem received the most attention; debt policy for governments was thought to be identical with that for individuals. The most important rule was to get into debt as seldom and as little as possible, and once in to get out with all possible speed. Borrowing was justified for productive undertakings, for durable consumption goods, and for emergencies. In the early days, to be sure, the States had used their credit power to increase the supply of money and capital, and thus to stimulate the expansion of the economy. The Federal Constitution deprived them of the power to issue money, but, until the Civil War, they continued to exercise an important influence on currency through State banks, which were regulated by the States and often heavily subsidized by State loans. Also, loans for internal improvements were an important expansive influence. State borrowing declined after the Civil War, and not until the motor vehicle stimulated highway building did State borrowing again reach such proportions that it might stimulate the whole economy.

Today the effect of State credit transactions on the economy as a whole differs only in degree from the effect of private credit transactions. The State usually has better credit than the private enterprise, and it is less influenced by considerations of direct financial returns. But the State's credit, like that of the private borrower, is limited. The monetary and credit powers, which permit unrestricted credit expansion, are vested with the Federal Government.

It was not until 1933 that the Federal Government began to conceive of the public debt as an instrument of fiscal and economic control. Most people, however, continue to consider the debt as a strictly institutional matter, as illustrated by the commonly heard criticism: "I have to live within my income; why shouldn't the Government?"

2. TRENDS IN INDEBTEDNESS

The Federal debt is approximately four times as great as it was a decade ago, but State and local debts declined slightly during the depression and today combined State and local debts are only a little above the 1932 level.

The proportion of Federal debts for revenue-producing enterprise has declined from its high point in 1934, but the proportion of State and local debts for revenue-producing enterprises has increased fairly steadily, so that for State and local governments a smaller proportion of the debt service falls on tax revenues than formerly. One-third of municipal debt is for revenue-producing enterprises.

Municipal bond defaults were large during the depression, but the number of municipalities in default has declined rapidly since 1936. The local debt situation today is fairly satisfactory, partly because of extensive Federal aid.

3. STATE-LOCAL COOPERATION

Extensive State controls of local debts began after the Civil War and have increased steadily. These controls have for the most part taken the form of restrictions on the amount and purpose of debts and have been designed to check reckless financing rather than to assist local governments already in difficulty.

More recently, there has been a tendency to supplement rigid laws with administrative controls. Flexible and continuous administrative controls have proved markedly successful in some States, e. g., New Jersey.

Direct State aid to relieve a difficult local debt situation, through State assumption, guaranty, or servicing of local debts, is still exceptional, although there were several instances of such aid during the depression. However, States have quite regularly provided their municipalities with protected markets for their securities, either through giving preference to such securities in investing State funds, or by forcing domestic financial corporations to give such preference in their investments. Some even forbid investment of State funds in "foreign" municipal bonds. Such protected investments have formed a substantial part of the local bond market.

States have generally exempted municipal securities from State and local taxes on intangibles, and most States have exempted the interest on bonds issued by their municipalities from State income taxes.

The North Carolina Local Government Commission apparently has more extensive powers over all local debts than any other State board or commission. The Commission must approve all local bonds and notes, and while its decision may be overruled by popular vote this has actually occurred in only one instance.[1] Although in practice it has used persuasion rather than coercion, the Commission may also take over the administration of the financial affairs of any defaulting local government. To what extent these controls can be credited with local debt reductions it would be difficult to say. In 1940 the per capita gross local debt was 7.6 percent lower than it was in 1932, as compared with a 5.2 percent reduction for all local debts in the United States during the same period.[2] The Commission also markets local issues, and this, according to Fesler, has enabled the municipalities to obtain more favorable terms.[3] The actual reduction in average rates for new financing has been substantial in the past decade, but not markedly different from interest rates for the municipalities of other States.

The North Carolina Commission has frequently been criticized both for failing to exercise its full powers of control and for undiscriminating marketing of local bond issues.[4] The New Jersey controls have ap-

[1] J. W. Fesler, "North Carolina's Local Government Commission," National Municipal Review, June 1941, p. 330.
[2] U. S. Department of Commerce, State and Local Government Debt: 1940.
[3] Fesler, op. cit., p. 332.
[4] See, e. g., Fesler, op. cit., p. 334, and B. U. Ratchford, "Work of the North Carolina Tax Commission," National Municipal Review, June 1936, p. 327.

parently been more effective. The powers of the New Jersey State officials are adequate and they seem to have been used to good advantage. Where the number of North Carolina municipalities in default at the beginning of 1941 was still 36 percent of the number in default 5 years earlier, the number of New Jersey municipalities in default had decreased in the same perod to 19 percent of the earlier number. This is not complete proof of the superiority of the New Jersey controls, since many other factors enter into the situation, but it tends to corroborate the opinion that the New Jersey system has been more successful in operation than that of North Carolina. Credit for this success is given largely to the fact that the original audit of New Jersey's municipal budget is thorough, and to the insistence of State officials on genuinely balanced budgets.

State assumption of local debts has occurred in recent years only in Arkansas. States have assisted with local debts in other ways, however. In some instances the State has either assumed the cost of debt service or distributed special revenues to the counties for this express purpose. In other instances the State has guaranteed local issues; occasionally the State itself has advanced the money.

It is apparent that much of the legislation providing for these different forms of assistance has been stimulated by some particular emergency. Except for Massachusetts, New Jersey, and North Carolina, there are no comprehensive plans for assisting local governments with their debt problems.

The tendency for the States to prevent unwise local borrowing rather than to rescue the local governments from excessive debts after these have been incurred is unquestionably sound, but the record of defaults during the depression of the thirties suggests that State restraints have been quite inadequate—at least until recently. Defaults reached approximately 15 percent of outstanding local issues at one time—a record that is but little better than that of the 1870's. In addition to these defaults, and largely because of them, municipal credit was so impaired that municipal bond offerings totaling nearly $500 millions failed to sell during the years 1933 and 1934.[5]

The abuse of public credit during earlier eras of American history led several States to write into their constitutions provisions forbidding State borrowing except in some cases "to suppress insurrection or repel invasion." State works of public improvement are virtually prohibited in many State constitutions. By constitutional amendment or otherwise, the construction and maintenance of highways is usually made an exception from this restriction. Only eight States can borrow freely at their own discretion, and some, such as Michigan, cannot borrow even in anticipation of taxes.[6] This self-imposed discipline is especially striking in view of the fact that municipalities are allowed much more freedom to borrow than the State itself possesses. Municipalities are circumscribed by many rules as to the exercise of their borrowing power, but these rules are frequently ineffective.

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[5] Commercial and Financial Chronicle: State and Municipal Compendium, June 30, 1934, and June 30, 1935.

[6] J. W. Sundelson, Budgetary Methods in National and State Governments, New York State Tax Commission, Special Report No. 14, Albany, 1938, pp. 22–23.

4. FEDERAL COOPERATION WITH STATE AND LOCAL GOVERNMENTS

(a) *History of Federal aid to State and local governments.*

Direct Federal aid to States for the reduction of debts began in 1790 when the Federal Government, after long debate, assumed the debts that the States had incurred during the Revolutionary War. This relieved the States of approximately $18 millions of a total of $30 millions of debt.[7] State debts increased rapidly, however, as a result of ambitious programs of internal improvements, and by the time that the Federal Government had paid off its own debt, State debts exceeded $150 millions.

Pressure from the States and from the supporters of the protective tariff led to the distribution of the surplus in 1837—$28 millions. This was designated a loan, but there seems to have been no serious expectation of repayment. Some States distributed it among their local governments or among their citizens on a straight per capita basis. Others used it to initiate improvements that ultimately cost them far more than the Federal funds available.[8] Thus, far from aiding in the reduction of State debts, this distribution stimulated further borrowing. Only four States used any part of the money for reduction of debt.[9]

The failure of some of the States to meet their obligations to the foreign holders of their bonds led to renewed agitation for Federal aid in the years immediately following the distribution of the Federal surplus.[10] This resulted in the Distribution Act of 1841 providing for the distribution of proceeds of public land sales to the States. A single distribution, amounting to less than $700,000 was made under this Act.[11] State debts had reached nearly $200 millions by this time, and nine States had defaulted by the end of 1842, but the Federal Government made no further move to assist them. Part of the Federal trust funds were invested during this period in State bonds, but this was because of the lack of Federal bonds rather than to assist the States. Moreover, the amounts involved were small. The total of these funds amounted to $2.5 millions in 1842, and they did not increase rapidly. By 1867, $2.7 millions of the $4.3 millions then invested in State bonds were in default. The Federal Government recovered part of this by withholding funds due from the United States to the defaulting State.[12]

The Civil War brought renewed borrowing by the States, and again the Federal Government came to their assistance. The Union States were reimbursed for $55 millions of the $112 millions borrowed for war purposes. The Confederate States, which received no aid, repudiated not only the war debts but also a substantial part of their reconstruction debts.[13]

During the remainder of the nineteenth century State debts declined, and there was little demand for Federal assistance. The in-

[7] The Federal Government agreed to assume $22 millions but final payments, for various reasons, were only $18 millions. (A. S. Bolles, Financial History of the United States, 1789–1860, Appleton, New York, 1883, p. 37, and B. U. Ratchford, American State Debts, Duke University Press, Durham, 1941, pp. 58–62.)

[8] T. H. Benton, Thirty Years View from 1820 to 1850, (2 vols.) New York, 1851, 1862, vol. 2, p. 39.

[9] E. G. Bourne, The History of the Surplus Revenue of 1837, Putnam, New York, 1885, passim.

[10] Benton, op. cit., vol. 2, pp. 240–245; H. C. Adams, Public Debts, Appleton, New York, 1887, pp. 295 ff.

[11] J. A. H. Keith and W. C. Bagley, The Nation and the Schools, Macmillan, New York, 1920, p. 61.

[12] Ratchford, op. cit., pp. 84, 242; Bolles, op. cit., pp. 595-596.

[13] Ratchford, op. cit., pp. 136, 140, 151, 184.

vestment of Federal trust funds in State securities decreased, but it had never been important. In 1902 the Secretary of the Treasury permitted banks used as depositaries for Federal funds to use State and municipal bonds as well as Federal bonds for security.[14] This was done to enable the banks to hold more Government funds than they could otherwise have held, rather than to improve the State and municipal bond market, which seems to have been satisfactory.

Beginning in the second decade of this century, the Postal Savings System offered a market for municipal bonds, since these bonds could be used for postal-savings collateral and were in fact the most usual form of collateral offered. Such deposits ranged between $100 and $200 millions until the depression, when they rose sharply to approximately $1 billion in 1933. This, too, was an accidental rather than a deliberate aid, but it has been regarded as an important factor in marketing municipal securities.[15] Since 1933 an increasing proportion of such funds has been invested directly in Federal securities, and funds with depositary banks had declined to $30 million in 1941.

Nor did the Federal Government offer other direct assistance. Federal grants-in-aid were small in the pre-depression period. Since they were designed to stimulate new State activities and normally had to be matched by State funds, they probably increased pressure on State treasuries rather than reduced it.

Indirect assistance came from the exemption of interest on State and local bonds from the Federal income tax. Although not intended as aid to State and local governments, this gave State and local securities a protected market that, with the increase in income tax rates during the First World War, probably served as an important factor in keeping interest rates low.

With the depression, the Federal Government embarked on an extensive policy of financial assistance to State and local governments that aided substantially in balancing the latter's budgets. The financial consequences of the depression were more serious for State and local governments than for the Federal Government, since the relief burden was their direct responsibility, and it tended to be distributed in inverse proportion to local resources. The situation became acute very early in many communities, and even in whole States. Federal aid was inevitable and it took many forms.

Direct financial aid came in the form of (1) Federal relief expenditures—both grants-in-aid to the States and direct Federal expenditures; (2) loans to State and local governments; (3) special financial assistance to defaulting municipalities; and (4) special legislation—the Municipal Bankruptcy Acts. Indirect financial aid came through (1) all the Federal Government activities that contributed to recovery; and, more specifically, (2) loans to corporations and private individuals that made it possible for them to pay State and local taxes; (3) the continuance of the tax exemption of interest from State and local securities; and (4) the Treasury's easy-money policy, which has kept the cost of borrowing low.

[14] D. R. Dewey, Financial History of the United States, 8th ed., Longmans, New York, 1922, p. 531.
[15] E. W. Kemmerer, Postal Savings, Princeton University Press, Princeton, 1917, p. 124.

(*b*) *Direct Federal financial aid.*

Considering direct financial aid first, there can be no doubt that the most important factor has been Federal relief expenditures, whether in the form of grants-in-aid to the States or direct Federal expenditures (notably those of the Work Projects Administration) in the States. The size of these expenditures, together with the fact that they have tended to be distributed in inverse proportion to local resources, must have brought substantial relief to State and local treasuries, which would otherwise have had to carry the brunt of the relief burden. In the early years of depression there were no Federal relief grants, unless the Federal highway grants, which were doubled (from $78 millions in 1930 to $156 millions in 1931) are regarded as relief aid. In 1933, however, Federal relief expenditures amounted to approximately $400 millions (nearly $600 millions if highway grants are included); in 1934 they increased to $2.5 billions; and from 1935 on they exceeded $3 billions annually except in 1938.

How much State and local expenditures would have been in the absence of Federal relief expenditures it is difficult to say. The percentage of public-relief and social-security costs met from State and local revenue sources dropped from 100, before depression, to 16 in 1935. Kilpatrick estimates that $6.8 billions of the $8.9 billions spent by the Federal Government for relief and public works, in the 3 years from 1933–34 through 1935–36, was either substituted for local expenditures from local funds or directly affected local funds.[16] The social-security program has demanded relatively greater State and local contributions in recent years than the Federal Emergency Relief Administration programs required in the early years of Federal aid. Even in 1938 and 1939, however, after the Federal Government had withdrawn from direct relief, and State unemployment benefits and matching social security grants were in operation, the State and local share had increased to only about one-third of the total. Expenditures from State and local sources for all forms of relief and social security rose from $356 millions in 1933 to $1,855 millions in 1939.[17] This is a substantial increase and some of the Federal programs—notably the social security matching grants and unemployment benefits—tended to stimulate rather than to reduce State and local expenditures. The unemployment benefits were not a charge on ordinary revenues, however, and the matching grants have not encouraged borrowing since they are a continuing charge.

It is clear that the State and local governments could not have spent as much for relief as they did spend had they been obliged to rely exclusively on their own resources; and it seems reasonably certain that the financial condition of State and local governments has been materially strengthened by the indirect, if not the direct, effect of these large expenditures. Most of the local governments must have gained directly, since the larger part of the residual State and local share falls on the States.

Loans to State and local governments from Federal corporations and agencies have played an important part in depression financing. These have come almost entirely through the Reconstruction Finance Corporation and the Public Works Administration, as can be seen in table 46.

16 W. Kilpatrick, "Federal Assistance to Municipal Recovery," National Municipal Review, July 1937, p. 337.

17 All the figures for Federal, State, and local expenditures are from an unpublished study of the National Resources Planning Board.

TABLE 46.—*Loans by Reconstruction Finance Corporation and Public Works Administration to State and local governments, 1932–1939*

[In millions]

Purpose of loan or type of security purchased	Total	1932-36 [1]	1936-39 [2]
Reconstruction Finance Corporation loans: [3]			
Self-liquidating projects	$408	$241	$167
Irrigation, levee, and drainage	89	64	25
School (payment of teachers' salaries)	22	22	
Securing repayment of deposits of public money in State funds	13	13	
Total Reconstruction Finance Corporation	532	340	192
Public Works Agency loans: [4]			
Revenue obligations	323	255	68
Tax obligations	249	234	15
Special-assessment bonds	11	9	2
Other securities	36	25	11
Total Public Works Agency	619	523	96
Grand total	1,151	863	288

[1] Reconstruction Finance Corporation loans through Dec. 31, 1936 and Public Works Agency loans through June 30, 1936.
[2] Data for Reconstruction Finance Corporation loans end Dec. 31, 1939, and for Public Works Agency loans Mar. 1, 1939.
[3] United States Department of Commerce, Statistical Abstract of the United States.
[4] Public Works Administration, America Builds, Washington, 1939, p. 276.

The Reconstruction Finance Corporation has been the most important lending agency, supplying funds to other government corporations as well as directly to private industry and to State and municipal governments. Its first loans to State and local governments consisted of the $300 millions of relief loans to States authorized in July 1932, and disbursed in the same fiscal year. These loans were canceled in 1938, at which time less than $20 millions had been repaid. The relief loans were supplemented, in 1932, by self-liquidating loans to State and local governments for public works. The first important loans of this nature were $40 millions to the Metropolitan Water District of Southern California and $62 millions to the San Francisco-Oakland Bridge Authority—both authorized in the fall of 1932. Thenceforward self-liquidating loans became an important factor in State and local borrowing.

The Public Works Administration was established in 1933, and also made loans to State and local governments for public works. Costs of State and local Public Works Administration projects to March 1, 1939, were estimated at nearly $4 billions. Of this sum 46 percent was met from State and local sources without Federal assistance, 38 percent came from Federal grants, and 16 percent—$629 millions—from Federal loans. About half of the loans, as shown in table 46, were in the form of special revenue bonds. Most of the remainder are serviced from general or special tax revenues.

During the first two years of operation, Public Works Administration loans to State and local governments were substantially larger than Reconstruction Finance Corporation loans. Since that time the Reconstruction Finance Corporation loans have been larger. As shown in table 47, combined Reconstruction Finance Corporation and Public Works Administration purchases were at their peak in 1933, when these agencies purchased $484 millions of the $1,128 millions of State and local securities marketed. In 1934 they purchased $288 millions of the $1,175 millions marketed. In 1935 and 1936 more

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favorable market conditions reduced sales to these two organizations, although the total volume of State and municipal bonds marketed remained approximately the same. The most important purchases of new issues by the Reconstruction Finance Corporation in recent years were those for the Harrisburg-Pittsburgh highway and a Philadelphia revenue trust issue for which the city has pledged rentals from the gas works.

TABLE 47.—*State and municipal bond sales, and amounts purchased by Reconstruction Finance Corporation and Public Works Administration, 1932–41*

Year	Amount of sales				Percent of sales		
	Total	To Reconstruction Finance Corporation	To Public Works Administration	To others	To Reconstruction Finance Corporation	To Public Works Administration	To others
	Millions	*Millions*	*Millions*	*Millions*			
1932	$937	$16	....	$921	1.7	....	98.3
1933	1,128	206	$278	644	17.4	24.6	58.0
1934	1,175	61	227	887	5.2	19.3	75.5
1935	1,196	58	21	1,117	4.8	1.8	93.4
1936	1,156	38	18	1,100	3.3	1.6	95.1
1937	984	58	51	875	5.9	5.2	88.9
1938	1,229	105	53	1,071	8.5	4.3	87.2
1939	1,099	39	19	1,041	3.5	1.7	94.8
1940	1,498	12	2	1,484	.8	.1	99.1
1941	1,229	159	1	1,069	12.9	.1	87.0
Total	11,631	752	670	10,209	6.5	5.8	87.7

Source: The Bond Buyer.

These self-liquidating loans and other issues for public works encouraged increased borrowing rather than assisted with debts already incurred. Local districts in financial difficulties first received assistance from the Reconstruction Finance Corporation in the latter part of 1933, when this agency was authorized to lend to defaulting drainage, levee, and irrigation districts for refinancing. Such loans never attained the proportions of the self-liquidating loans, but they have amounted to nearly $90 millions. Other loans to State and local governments in financial difficulty include one of $22 millions to the Chicago school district for the payment of teachers' salaries, made in 1934; a few small loans to other school districts in difficulties; a loan of $13 millions to the State of Wisconsin in 1933, to free funds of Wisconsin municipalities that were tied up in closed banks; and a $136 million refunding loan to Arkansas in 1941. The terms of this loan were enough better than those offered by the banks to effect a saving of $28 millions to the State over the entire lifetime of the bonds.[18]

These securities have been remarketed by the Reconstruction Finance Corporation as opportunity offered. Beginning in August 1934, the Reconstruction Finance Corporation has been purchasing securities from the Public Works Administration and reselling them, together with the issues originally purchased by the Reconstruction Finance Corporation. By the end of 1939 the Reconstruction Finance Corporation had purchased $623 millions from the Public Works Administration and resold $502 millions. Most of these were State and municipal securities. On this same date the Reconstruction

[18] New York Times, February 28, 1941, p. 30.

Finance Corporation was still holding only $170 millions of the $532 millions of the municipal securities which it had previously purchased directly from municipalities.[19] It resold the largest part of the Arkansas bonds shortly after purchasing them.[20] The profits on these resales have been substantial; however, only the better securities have been remarketed. Delinquencies in interest payments or principal were reported for 325 out of nearly 2,900 Public Works Administration purchases on March 1, 1939.[21] This suggests that a number of the loans have involved local governments in financial difficulties rather than improved their financial position. These were the smaller districts and the delinquencies involved a much smaller proportion of the borrowed funds than of the borrowing districts.

Municipalities have obtained funds at lower rates than would have been possible through sales in the usual channels. Many of the securities purchased by the Reconstruction Finance Corporation and Public Works Administration could not have been marketed at any reasonable price to the general public. There are, however, a few cases of large projects, for which the borrowing has been spread over several years, where the increasingly favorable market has made it possible to borrow through the banks at better rates than originally granted by Federal agencies. For instance, the original issue of the Metropolitan Water District of Southern California bonds was at 5 percent. These were refunded by the Reconstruction Finance Corporation at 4 percent in 1938 and they were still remarketed by the Reconstruction Finance Corporation at a substantial profit. While the municipalities are always free to seek loans from the banks, it has been suggested that they may hesitate to do so since they might later need assistance from the Reconstruction Finance Corporation and find it difficult to obtain it. There is no evidence that such fears are justified, and while the Reconstruction Finance Corporation clearly has large powers over borrowing municipalities, it is not forced by the profit motive to exercise its power to the disadvantage of the municipalities. There is no apparent necessity, however, for the secrecy with which Reconstruction Finance Corporation affairs have been conducted.

These programs have definitely encouraged State and local borrowing. This was, of course, in keeping with the Federal Government's pump-priming policy. The Public Works Administration grants were substantial enough to encourage new projects that the local governments would not have undertaken if the full cost had fallen on local resources. Moreover, the Federal Government undertook to lend a large part of the local share of the cost. Municipalities that found no market for their bonds through the banks could sell them to the Federal Government. Where no debt margin was available the debt limit could often be avoided by the use of revenue bonds or the establishment of a new special district—a public authority. In some instances States passed new laws relaxing the usual debt procedure for private sale to Federal agencies, and Federal officials assisted local authorities in working out the legal problems involved in floating the new issues.

The aid thus given may, in some instances, have merely deferred the day of reckoning rather than actually improving the financial position of the borrowing governmental unit. Bird cites the case of

[19] Statistical Abstract of the United States, 1940, p. 285.
[20] New York Times, March 19 and 29, 1941.
[21] Public Works Administration, America Builds, Washington, 1939, p. 69.

a small town with a 43 percent tax delinquency in 1933 and a per capita debt of $280 (four times the average for towns of that population), which was just beginning to get its finances in order when it was tempted to borrow from the Public Works Administration for a school building that was needlessly expensive. The result was to bring the per capita debt to $320.[22] It is too early to know how many such cases of undiscriminating borrowing were encouraged by Federal policies. The amount of defaults to date are relatively small, but markets have been improving and the date of repayment of principal has in many instances been deferred. Most municipalities have not been so easily tempted, however. The total gross municipal debt is lower than it was in 1932, and that part of it which is classified as productive is larger.

The Reconstruction Finance Corporation policies were better designed to improve the financial position of the municipalities aided than those of the Public Works Administration. The latter was concerned only with public works. Construction was the principal objective of this organization and the way in which construction was financed was secondary. Moreover only about half of the bonds purchased were revenue bonds. Schools and highways may be worth their cost to the community, but they produce no immediate tax revenues.

The Reconstruction Finance Corporation, on the other hand, loaned for construction only if the project was revenue producing. And it was the Reconstruction Finance Corporation, and not the Public Works Administration, that engaged in refinancing of districts in financial difficulties. The chairman of the Reconstruction Finance Corporation reported in 1939, that 99 percent of the reorganized districts were meeting interest and principal payments in full,[23] whereas the Public Works Administration reported 11 percent delinquency at approximately the same date.[24]

State and local bond issues sold directly to the general public (i. e., to purchasers other than the Public Works Administration and the Reconstruction Finance Corporation) increased from the low point of 1932, but many of the new securities were refunding issues. New issues sold to the general public totaled $644 millions in 1933 whereas those sold to the Public Works Administration and Reconstruction Finance Corporation totaled $484 millions. In 1934 issues sold to the general public were approximately three times those purchased by the Reconstruction Finance Corporation and Public Works Administration.[25] Thereafter sales to Government agencies were much the smaller share of the total. In contrast to the large amount of loans for new undertakings—more than $1 billion in all—loans to districts in financial difficulties have amounted to only about one-quarter of a billion, including the $136 million Arkansas refunding loan.

The war emergency promises to expand Federal aid to municipalities once more. The rapid shifts in population resulting from new defense industries have brought with them a demand for new and expensive municipal services—extension of water and sewer systems, laying out of new streets, new housing, and new schools. Federal

[22] F. L. Bird, "Cities and Their Debt Burdens," National Municipal Review, January 1936, p. 15.
[23] Jesse H. Jones, Reconstruction Finance Corporation Seven-Year Report, Washington, 1939, p. 7.
[24] Public Works Administration, America Builds, Washington, 1939, p. 68.
[25] See table 47. Compare with figures for sales to the general public in the Commercial and Financial Chronicle, "State and Municipal Compendium."

funds of $150 millions were set aside for aid to such municipalities even before war was declared. An additional $150 millions was appropriated in January, 1942. Of this sum $189 millions had been allocated in grants and $8 millions in loans by June 27, 1942.[26]

The Federal Municipal Debt Adjustment Act of 1934 offered a different type of assistance. States cannot impair contract obligations and therefore cannot force minority creditors to accept an agreement approved by the majority. The Federal Government has this power, however, and this act provided that action could be taken by Federal district courts for defaulting municipalities, upon application from a prescribed proportion of creditors. The final adjustment must be accepted by holders of three-fourths of the debts affected.

More than one-third of the States passed enabling acts to permit their political subdivisions to take advantage of this legislation, although it was uncertain that such additional legislation was necessary.[27] A relatively small number of districts (most of them California and Arkansas irrigation and drainage districts) filed petitions under this act before it was declared unconstitutional in 1936.[28] It was replaced by a new and similar act in 1937 to be in force until June 30, 1940.[29] This act has been extended twice since, the second extension running to June 30, 1946.[30]

The relatively small number of cases brought under the first act is attributed by Hillhouse to its novelty, the inability in some instances to obtain consent of the required number of creditors, the fact that in most cases so drastic a step was not needed, and the fact that the existence of such machinery was often sufficient to bring creditors to terms voluntarily.[31] The fact that a new and similar measure was passed so promptly after the original one was invalidated, and that the life of the new measure has since been extended, suggests that the measure served a useful purpose. As of April 24, 1942, 102 cities, 10 counties, 20 school districts, and 110 special districts had filed petitions under the 1937 act.[32]

To be really effective such legislation must be accompanied by State assistance and controls, since only the State has the necessary authority over local tax levies and financial administration to enforce the agreements thus made.

(*c*) *Indirect Federal financial aid.*

Federal policies of indirect aid to State and local finances are many, but their importance cannot be stated in quantitative terms. State and local tax collections and credit improved with the rising national income, and insofar as Federal borrowing increased purchasing power and aided in recovery it contributed to the better fiscal position of the States and their municipalities. A few measures can be singled out, however, as having special, though indirect, bearing on State and local finances.

The loans of Federal corporations and agencies that were made to private corporations and individuals not only increased purchasing

[26] Federal Works Administration, War Public Works Project List, June 27, 1942.
[27] Hillhouse, Municipal Bonds, p. 344.
[28] *Ashton* v. *Cameron County Water Improvement District No. 1*, 298 U. S. 513 (1936).
[29] Upheld by the Supreme Court (*U. S.* v. *Bekins*, 304 U. S. 27 (1938)).
[30] Public Law 622, approved June 22, 1942.
[31] Hillhouse, op. cit., p. 388.
[32] Report, H. R. 2119, 77th Cong., 1st sess., Extending the Municipal Bankruptcy Act, May 12, 1942.

power, but probably led directly to improved State and local tax collections. (The amounts of these loans are shown in table 48.) Property tax delinquencies in 150 cities rose from 10 to 26 percent between 1930 and 1933 and have declined steadily since, falling below 9 percent in 1940.[33] Since the decline in delinquencies follows general business conditions fairly closely, the contribution of Federal loans toward this decrease cannot be measured. Bird credits a large part of the increase in back taxes in urban areas in 1934 to the $100 millions advanced for this purpose by the Home Owners' Loan Corporation.[34] The Federal Home Loan Bank Board reported $234 millions cash payments to county and municipal treasuries for delinquent taxes prior to June 30, 1935.[35]

TABLE 48.—*Oustanding loans of Government corporations and credit agencies, 1929–41* [1]

[In millions]

Agency	1929	1930	1931	1932	1933	1934	1935
Federal land banks	[2] $1,199	[2] $1,189	$1,184	$1,147	$1,118	$1,705	$2,126
Federal intermediate credit banks	[2] 76	[2] 130	137	116	82	198	178
Farm Credit Administration [3]	8	158	395	577	551	240	287
Farm Security Administration							
Rural Electrification Administration							
Federal Farm Mortgage Corporation						379	733
United States Maritime Commission and United States Shipping Board	61	78	100	139	158	143	120
Reconstruction Finance Corporation				1,128	1,968	2,667	1,380
Public Works Administration						135	304
Commodity Credit Corporation						205	152
Export-Import Bank of Washington						3	
Home Owners' Loan Corporation						834	2,658
Federal home loan banks						86	79
Federal National Mortgage Association							
United States Housing Authority							
All other [4]	69	61	45	44	43	135	53
Total	1,413	1,616	1,861	3,151	3,920	6,730	8,070

Agency	1936	1937	1938	1939	1940	1941
Federal land banks	$2,128	$2,075	$2,018	$1,941	$1,880	$1,818
Federal intermediate credit banks	193	207	223	221	232	255
Farm Credit Administration [3]	334	404	279	272	267	263
Farm Security Administration			169	256	308	461
Rural Electrification Administration	1	8	12	122	220	289
Federal Farm Mortgage Corporation	827	831	786	718	669	630
United States Maritime Commission and United States Shipping Board	105	79	61	49	44	33
Reconstruction Finance Corporation	1,255	1,158	1,216	1,045	1,061	1,082
Public Works Administration	139	125	29	55	95	97
Commodity Credit Corporation	239	124	241	372	169	244
Export-Import Bank of Washington	17	17	15	30	52	114
Home Owners' Loan Corporation	2,945	2,556	2,265	2,081	2,013	1,870
Federal home loan banks	119	167	196	169	157	170
Federal National Mortgage Association				125	163	194
United States Housing Authority			13	68	87	316
All other [4]	57	64	152	81	275	274
Total	8,359	7,815	7,675	7,605	7,692	8,110

[1] Data from Annual Report of the Secretary of the Treasury. Figures are for loans outstanding on June 30. Figures are net, intercorporate loans being deducted. In some cases, however, they have been deducted from the loans of the borrowing corporation and in some cases from those of the lending corporation.

[2] Figures are for loans outstanding on Dec. 31.

[3] Including Farm Loan Board loans and emergency crop and drought loans.

[4] Including those that have at no time had as much as $100 millions outstanding, viz, Federal Deposit Insurance Corporation, banks for cooperatives, Regional Agricultural Credit Corporation, Disaster Loan Corporation, Electric Home and Farm Authority, RFC Mortgage Company, Interior Department (Indian loans), Puerto Rico Reconstruction Administration, U. S. Railroad Administration, U. S. Spruce Production Corporation, Navy Department (sale of surplus war materials).

[33] F. L. Bird, The Trend of Tax Delinquency, 1930–40, New York, 1941, p. 14.

[34] F. L. Bird, "Extent and Distribution of Urban Tax Delinquency," Law and Contemporary Problems, June 1936, p. 340.

[35] Third Annual Report, p. 1.

The loans of the Federal land banks and of the Land Bank Commissioner are likewise used in part for tax payments. It is estimated that $60 millions were used for this purpose between May 1, 1933, and June 30, 1936 ($34 millions from the Federal land banks and $26 millions from the Land Bank Commissioner).[36] This total had increased to only $64 millions by December 31, 1938.[37] Thus it is apparent that the Home Owners' Loan Corporation contributed more directly toward meeting the delinquent tax problem than the Federal land banks. However, loans to farmers and home owners, whatever the immediate use of the money thus obtained, will inevitably assist these real-estate owners to pay taxes before they become delinquent, and the total amount of loans, rather than the amount going for delinquent taxes, will contribute thus indirectly to municipal solvency.

Agricultural loans of all kinds from Federal corporations and credit agencies increased nearly $800 millions in 1934 and more than $800 millions in 1935. Since that time they have varied little from year to year, but the total is about $3.5 billions. Loans of the Home Owners' Loan Corporation and Federal home-loan banks rose from nothing in 1933 to $900 millions in 1934. They showed an increase of $800 millions in 1935 and $300 millions more in 1936. Since that time these loans have decreased; the power of the Home Owners' Loan Corporation to make such loans expired in June 1936. In this connection the activities of the Federal Housing Administration should be noted. This agency does not make loans, but it has insured loans for home mortgages and real estate improvements to the extent of $4.3 billions.[38]

The Reconstruction Finance Corporation loans to railroads totaled $800 millions (including $200 millions originally made by the Public Works Administration). Of this amount $32 millions was approved specifically for taxes.[39]

The figures cited above indicate that between $300 and $400 millions of Federal loans went directly to the payment of State and local taxes during the years 1933 to 1936. The extent to which tax payments were improved indirectly by these Federal loans cannot be measured. The loans to banks and trust companies, which totaled more than $3.3 billions, did much to keep these banks open and functioning. This must have been an important factor in facilitating tax collections on the one hand, and in keeping municipal deposits liquid on the other. Finally, the Reconstruction Finance Corporation Mortgage Company has made loans to discount corporations which, in turn, make loans to taxpayers, at a maximum of 4 percent interest, for the payment of back taxes.[40]

The Securities Act of 1933 and the Securities Exchange Act of 1934 were probably of assistance in the marketing of State and municipal securities insofar as they checked new issues of competing private corporation securities. Any advantage that this may have offered was probably limited to the early period before the obligations of the sellers were clearly defined, since the issue of the type of private cor-

[36] Farm Credit Quarterly, September 30, 1936, p. 5.
[37] Ibid., March 1939, p. 8.
[38] R. Foulke, "The 29 Federal Lending Agencies and How They Grew," Dun's Review, November 1941, p. 9.
[39] Federal Coordinator of Transportation, Public Aids to Transportation, Washington, 1938–40, vol. 2, p. 79.
[40] New York Times, August 28, 1936.

poration securities with which State and municipal bonds are apt to compete is not seriously checked by the provisions of this legislation.

The total loans of all Federal corporations and lending agencies are given in table 48. It will be noted that the largest increases occurred in the years 1932 to 1935, inclusive.

The yield of municipal bonds in 1941 was just half what it was in 1929.[41] The median rate for new issues in 1940 was 3 percent as compared with 4½ percent 10 years earlier; and whereas bond issues with interest rates under 4 percent were negligible in 1930, one-fourth of the total were issued at 2 percent in 1940.[42]

One factor that keeps interest rates on State and local bonds low is tax exemption. Exemption of interest on State and local bonds from the Federal personal income tax is not a new policy, nor is it specifically designed to aid municipalities. As income tax rates increase, however, exemption may considerably facilitate municipal financing, at least if one may judge by State and local protests against removing this feature.

The recent decline in interest rates has been shared by taxable and tax-exempt issues equally, so that tax exemption cannot be held responsible for any considerable part of this decline. The extent to which interest rates are reduced by exemption is variously estimated at from 0.25 to 0.60 of 1 percent.[43] This represents an annual saving of $50 to $100 millions in interest.

Another factor that has kept municipal bond interest rates low in recent years is the Treasury's easy-money policy. Municipal securities are in competition with other investments and low-interest rates on other types of loans keep the rates at which municipalities can borrow low.

5. GAINS AND LIMITATIONS OF INTERGOVERNMENTAL DEBT COOPERATION

(a) *Debt control.*

As has been observed in the previous historical sketch, intergovernmental cooperation in administering debts and formulating debt policy takes various forms. The top governments may control the debt policy of their subdivisions through more or less rigid requirements for borrowing. The purpose of such controls is to insure solvency, and to confine borrowing either to revenue-producing enterprise or to clearly exceptional outlays. These controls take the form of limiting the amount of borrowing (usually in relation to the size of the tax base), specifying purposes, length of life of specific bond issues, interest rates, methods of repayment, and other requirements for bond issues that will protect creditors and taxpayers. In this country the National Government has no such control over the States, but the State governments have the power to limit local debts and have, in some cases, restricted them rather severely.

The advantage of such controls depends on the superior judgment of State over local officials, or at least on a more disinterested judgment. The disadvantage lies in lack of knowledge of and adaptability to specific local conditions. The consensus seems to be that these

[41] Federal Reserve Board index.

[42] Commercial and Financial Chronicle, "State and Municipal Compendium."

[43] C. H. Chatters, "The Case Against Taxation of Governmental Securities," Annals of the American Academy of Political and Social Science, March 1941, p. 74. Estimates as high as 1 percent can be found but these are generally regarded as excessive.

controls have for the most part been beneficial to creditors and citizens alike. There is more criticism of the lack of such controls than of their interference with reasonable local financing, although in some instances they may have been needlessly rigid. The increasing emphasis on administrative controls, such as those of New Jersey, is a sound development.

(*b*) *Forms of direct debt assistance.*

A second method of intergovernmental cooperation—the reverse of debt controls—is definite assistance rendered by one government to another in borrowing. This is normally assistance rendered by the upper levels of government to the lower levels. It may take the form of (1) a direct loan, such as the Reconstruction Finance Corporation relief loans to the States, the Public Works Administration loans to both State and local governments, the Massachusetts loans to municipalities to cover tax delinquencies, and the California relief loans to municipalities. Or it may take the form of (2) a State guaranty of a local issue, as for example in New Hampshire. In either case the underlying government is able to borrow at a more favorable rate than it could otherwise obtain. In some cases, doubtless, it would find no market at all with private investors.

Such loans and guaranties have usually been restricted to real emergencies and they have been valuable under these circumstances. The device might be extended to all borrowing to give the smaller jurisdictions the benefit of the superior borrowing power of the larger. Such procedure would be subject to certain risks, however. The officials approving the loans would normally have somewhat less responsibility than investment bankers and would be subject to a certain amount of political pressure. Consequently, they might be unduly generous in their approval. Also, the borrowing jurisdiction would be subject to increasing controls from the lending jurisdiction.

Another form of debt assistance that brings direct financial saving to the beneficiary government is (3) the servicing of the debt of one jurisdiction from the revenues of another jurisdiction. This has usually taken place at some period after the debt was incurred, as when a State takes over highways originally built by the counties, and agrees to meet the debt charges on these. Since there has been a definite transfer of responsibility for the highways in these instances, it seems reasonable to include debt charges with current costs of maintenance and construction. To do so does not, of course, contribute to a better highway system, as State responsibility for maintenance and construction presumably does. But if the State wishes to extend the benefits of its better tax-collecting facilities to local governments, this offers an opportunity for doing so without undermining local responsibility.

Where the device of borrowing by one jurisdiction and servicing the debt by another has been used because the jurisdiction that wished to borrow in the first place was prohibited from doing so by some constitutional restriction, the merits of the arrangement are not so clear. Only when the restrictions are unreasonable and an emergency precludes resort to constitutional amendments could such cooperation be really acceptable.

The clearest case of financial assistance comes when (4) one government assumes the debt of another. The outstanding instance of this in the recent history of this country is the Arkansas assumption of local highway debts. In this case the highways were taken over with their debts. But in general any disposition of the upper levels of government to assume the debts of their subdivisions offers a dangerous precedent, since it might encourage local governments to borrow recklessly if they had any hope that in the end the State would bail them out. On the whole the States have shown more interest in preventing reckless local borrowing than in encouraging it. And the Federal Government, likewise, has shown far less readiness to assist the States in this fashion than have most other Federal States. Except for the assumption of part of the State war debts after the Revolution and again after the Civil War, the Federal Government has made no move to assist the States in this manner, even in cases of default. The cancelation of the relief debt is in a different category, since it was a direct loan from the Federal Government in the first instance, and was part of a program that was largely stimulated by the Federal Government and generously supported by it in the form of outright grants as well as loans.

(c) *Forms of indirect debt assistance.*

There are many less direct forms of financial aid. Substantial assistance has sometimes been given through (1) the investment of the funds of one governmental jurisdiction in the obligations of another. Where this has taken the form of the upper level of government investing in the bonds of its own subdivisions it has often been for the definite purpose of assisting the subdivisions financially, and in some States this has offered local governments an important market. Where the subordinate units invest in the securities of the overlying governments it has usually been done for the sake of safe investments, although this has occasionally been forced, as in the case of the Unemployment Trust Fund. Whatever the reason for such investments, they provide material assistance to the governments whose bonds enjoy these protected markets. Insofar as the officials making these investments have special knowledge of the financial condition of the borrowing units that enables them to pick up bargains, this type of investing may benefit the creditor government also; but if investments are dictated by political expediency the financial position of the investing government will be impaired, and local governments may be encouraged to borrow although their financial condition does not justify securing funds in this manner.

Much the same form of aid comes from (2) State regulation of the investments of domestic financial corporations that forces them to give preference to the bonds of domestic municipalities in making their investments. This practice brings no benefits to the financial corporations thus controlled and lacks the justification of special knowledge which can be advanced in support of State investment in domestic municipal securities.

A small number of States have assisted their municipalities by (3) marketing their bonds for them. This special service may be of genuine assistance, particularly if the State officials give local officials competent advice as to the terms of the issue and give full information to prospective buyers. There is some danger, however, that political pressure or local pride will lead State officials to sell poor securities as well as good ones. While such sales are not accompanied by State guaranties they at least seem to carry State approval.

Another form of indirect aid comes from (4) tax exemption. The exemption of interest on Federal bonds from State income taxes, and the exemption of interest on State and local bonds from Federal income tax, is another form of protecting the government bond market, although not originally designed for this purpose. The advantage goes primarily to the State and local governments since most State taxes are not heavy enough to make an important difference. States usually favor their municipalities by exempting the interest on these securities from the State tax, and States quite commonly exempt both State and local bonds from property taxes. Such exemptions are undoubtedly of value in obtaining favorable terms for loans, but it seems unlikely that this is sufficient compensation for the inequalities in the tax burden that result. Such inequalities are inevitable as long as investors are not in a position to profit equally by these exemptions. On the whole, State and municipal bonds will be sounder if they are forced to compete with other securities on equal terms.

Finally, (5) the Federal Government's easy-money policy has been distinctly favorable to State and local borrowing in recent years. Since this policy has not been pursued in the interest of a favorable State and local bond market, and since it benefits all borrowers equally, its merits and shortcomings must be judged by other standards which do not fall within the scope of this study.

(*d*) *Assistance to weak districts.*

The forms of cooperation discussed thus far have been extended to all the governmental units of a specific class, regardless of special needs. Aid to weak districts may take the form of skilled administrative assistance and advice or direct financial aid.

Administrative assistance of the type offered by the various Massachusetts and New Jersey finance commissions is particularly useful in cases of default arising primarily from inefficient local administration. Such State administration may achieve better tax collections, refunding at lower interest rates, and a program of regular debt payments, depending on circumstances and the powers of the commission in question. Where default arises from extreme poverty, however, efficient administration is not enough. Definite financial aid is needed. Where debts have been incurred in the past, such aid may extend to assistance with debt service or even assumption of the debt under exceptional circumstances. When the poverty is the result of temporary circumstances a relief loan may be a satisfactory solution. But if the lack of local resources is a continuing one, the need is for grants-in-aid, or State assumption of hitherto local functions, or redistricting, rather than specific assistance in debt payments. Intergovernmental debt cooperation will not bring permanent relief to the poor districts.

(*e*) *Countercycle debt policies.*

In the discussion thus far, the tests of the value of the different forms of intergovernmental debt cooperation that have been applied are the tests of solvency, and equalization or reduction of the tax burden. No consideration has been given to debt policies designed to minimize business fluctuations. The deliberate use of government borrowing and repayment of debt as a device to regulate business fluctuations and maintain full employment is still a controversial issue. But it is one that must be taken seriously. If this is accepted as an appropriate function of government, however, it is clear that the chief responsibility must fall on the Federal Government, since only the Federal Government has sufficient resources and authority to make it effective.

During the worst years of the recent depression local debts were decreased, although both the need for relief and for increased purchasing power required further borrowing. This was largely the result of rigid local debt limits. It was due partly, also, to failure of local credit because of delinquent taxes and defaults. Local governments were urged to borrow, and State governments were urged to remove the limits that prevented borrowing. It is not clear, however, that more local borrowing would have been desirable in the long run, even if it had been legally possible. The most urgent need was in the poorest areas, and while in some instances the poverty was quite temporary, in other instances the depression merely accentuated a long-standing weakness. A general relaxing of local debt restrictions would have unquestionably multiplied defaults out of proportion to the increased purchasing power thus created.

At present State and local governments are being exhorted to pay off debts and build up surpluses in the interest of checking immediate inflation and strengthening their financial position so that borrowing will be possible in the post-war period when it is needed to maintain full employment. Insofar as this form of cooperation is feasible it has everything to recommend it. There is no conflict here between the two objectives of ultimate solvency and minimizing industrial fluctuations.

The important contribution that State and local governments can make toward continuous full employment is to provide long-term programs for public works, which can be timed to take up some of the slack of private enterprise. If State and local authorities can be persuaded, also, to pay off debts in periods of rising income, and reserve their borrowing powers for periods of falling income, something will be gained. It is, of course, desirable for the State and local governments to contribute as far as possible to the cost of their own works projects, in the interests of responsible administration. But for State or local governments to risk solvency in the interests of full employment would be unwise. The Federal Government itself may well loan money to State and local governments for public works when these are needed to maintain full employment, just as it has during the past decade. But if loans are expanded in time of depression it should only be to districts in temporary need, which can reasonably be expected, according to the usual tests of sound financing, to meet these new obligations. When local resources are inadequate, grants rather than loans are called for.

There is no sound reason for abandoning the conventional tests of a sound State and local debt policy at a time when greater purchasing power is needed. The Federal debt is already approximately 4 times that of State and local governments. By the end of the war it may well be 20 times as great. Under these circumstances any reasonable expansion or contraction of State and local debts would be relatively ineffective. Full employment is a national problem and the main responsibility for dealing with it must remain with the National Government. This is not to say that State and local cooperation to facilitate Federal programs is unimportant.

The question of whether the Federal Government should seek a further centralization of the fiscal system in order to avoid uncoordinated municipal-State-Federal debt policy has been discussed elsewhere. Considerable centralization has occurred; Federal programs have stemmed State and local deflation with loans; States and municipalities are becoming more cycle-conscious; local borrowing during depressions is facilitated by Federal policy in keeping the interest rate low. The wholesale transference of State and local taxes and expenditures to the Federal Government to facilitate counter-deflation policy is unnecessary and undesirable.

B. Municipal Financial Problems and the General Property Tax

1. INTRODUCTION

Reference has already been made to the so-called financial plight of the cities. The plight, if so it may be called, tends to be greatest in the case of the large cities. The reason for this is that the per capita cost of government increases with the size of the city.

It has long been apparent that the large cities are becoming extremely important in our national life. New York, Chicago, Detroit, and Boston each have greater budgets than the States which contain them. The Urbanism Committee reported to the National Resources Committee in 1939 that the 22 metropolitan districts in the United States accounted for over one-fifth of the nation's total population.[44] The committee also expressed the view that intergovernmental relations had become a key problem for these areas.

There can be little doubt that local governments, particularly city governments, are "in a bad way" from the fiscal standpoint. The recent depression caught them ill-prepared for an emergency; many were obliged to borrow heavily for current expenses, and refunding of maturing obligations was common. The spectacle of a city like New York, popularly regarded as "the gold coast" of a rich country, going through one financial crisis after another, obliged to adopt a sales tax which its mayor had successfully attacked in Congress, and frankly conceding its future dependence on Federal revenues, is evidence enough that something is wrong in local fiscal institutions. New York is not unique in its predicament. Most cities have been living from hand to mouth in the hope that something would turn up.

The attitude of municipal officials has grown increasingly critical. One of them writes that "in the field of taxation the city is practically powerless" and has been placed in a "financial and administrative strait jacket"; another deplores the fact that "municipalities are facing a post-war period when local governments will find it necessary more and more to go to the central government for Federal assistance with the resulting placing of control."[45]

Another spokesman for the cities, referring to the latter as a "fiscal stepchild," presents their case for a more adequate revenue system as follows:[46]

> State and Federal Governments have taken the more lucrative sources of revenue, while cities have largely had to worry along with the general property

[44] Urban Government, vol. 1 of the Supplementary Report of the Urbanism Committee to the National Resources Committee, 1939, p. 4.
[45] Letters supplied the authors by Carl Chatters, Municipal Finance Officers Association, 1942.
[46] A. M. Hillhouse, New Sources of Municipal Revenue, Municipal Finance Officers Association, 1935, p. 1.

tax. The result is that some of our most important governments (in terms of size and services rendered) are without adequate revenue sources. This is intolerable.

The author adds significantly:

Striving for larger shares in State-collected gasoline, public utility, sales and liquor taxes, the cities cannot ignore actual or threatened entrance of the Federal Government into the same field.

And finally: [47]

The local units hold the least desirable position in the total tax system. Limited in area and jurisdictional powers, they cannot well administer sales, gasoline, income, inheritance, and other taxes. And equally unfortunately for the cities, they must still look largely to the State government for their taxing powers.

No doubt much of the blame for these predicaments can be placed at the door of the States, in whose legislative councils cities have for years been scandalously under-represented. Cities have often shared very inadequately in newly developed State revenues, particularly in motor-vehicle tax revenues. More importantly, the States have undermined and strait-jacketed general property tax expansion, either with exemptions or more commonly with ceiling limitations. The cities, in some instances, have their own mismanagement to blame for part or all of their financial troubles. But the general rise in competence of officials in posts of municipal responsibility has been one of the bright spots in the recent evolution of American government. It may well be that "the best managed of our cities are ahead of the Federal Government in the quality of their administration." The Federal Government is somewhat involved in the causes which have produced financial problems in cities. This has been described by one writer as follows:

In the past 10 years, new and extensive social responsibilities have been thrust on local government by economic changes, the effects of which have outlasted the depression and may be regarded as permanent * * * . Local governmental spending has been stimulated * * * by a wide range of grants from the State and Federal Governments * * * what is even more significant, these policies have developed standards of service to which the public has become accustomed and from which it henceforth will be impossible to retreat.[48]

The growing disparity between urban expenditures and urban property tax revenues is illustrated in table 49, which shows index numbers of total current expenses (excluding capital outlays and public service enterprises), assessed valuations, and general property tax revenues for the 10 largest cities in the United States. Except for the brief period of decline (1932–34), expenditures rose steadily to new high levels in 1939. Property-tax revenues also increased in most years, although not at the same rate, resulting in an ever-widening gap between these receipts and total expenditures. Furthermore these increased tax yields were obtained in the face of declining assessed values. Tax rates rose even more than yields.[49]

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[47] Ibid., p. 2.

[48] Thomas H. Reed, Federal-State-Local Fiscal Relations, Municipal Finance Officers Association, Chicago, 1942.

[49] Edwin H. Spengler, Preliminary Report on Urban Financing, unpublished manuscript prepared for the National Resources Planning Board and in consultation with the staff of the Committee on Intergovernmental Fiscal Relations.

TABLE 49.—*Indexes of current expenditures, assessed valuations, and property-tax revenues for the 10 largest cities in the United States, 1925–39*

[1926=100]

Year	Current expenditures	Assessed valuations	Property-tax revenue	Year	Current expenditures	Assessed valuations	Property-tax revenue
1925	93	93	92	1933	131	114	102
1926	100	100	100	1934	132	106	109
1927	107	115	106	1935	135	103	124
1928	115	120	113	1936	140	102	112
1929	121	125	108	1937	144	102	121
1930	129	130	116	1938	152	105	125
1931	136	130	123	1939	153	(1)	122
1932	134	124	111				

[1] Not available.

Source: Table from Edwin H. Spengler, Preliminary Report on Urban Financing, unpublished manuscript prepared for the National Resources Planning Board and in consultation with the staff of the Committee on Intergovernmental Fiscal Relations.

The cities have claimed the privilege, and some have found it possible, to develop some diversification of revenues. Thus we find, for example, municipal sales taxes in New York and New Orleans, a flat earned-income tax in Philadelphia, a license tax based on volume of business in Louisville and Richmond, a 1-cent gasoline, 1-cent bottle beer, and 2-cent cigarette tax in Birmingham, and a gasoline, automobile license, and cigarette tax in Kansas City. But these developments involve piling taxes three deep in a number of cases and they represent at best additional complications in an already highly complicated revenue system.

2. SUBURBAN DEVELOPMENT

The cities have encountered many problems as a result of the movement of population and industry toward the suburbs of these municipalities. "The population of suburban areas grew at a rate nearly three times that of their central cities between 1930 and 1940." [50] This has created confusion in the field of public expenditures; not infrequently the city proper has been called upon to provide certain services, such as fire protection, which the suburb was not equipped to supply. Occasionally the city finances a system of rapid transit that is used chiefly to carry the metropolitan population to and from the city and the latter is thus said to "subsidize its own competition." Services frequently furnished to suburbs, sometimes at less than cost, include water, sewers, fire protection, and schools. Sometimes these matters have been handled by the creation of special metropolitan districts. This working arrangement has its advantages, but it adds considerably to an already complicated pattern of government. The complication could be reduced, however, if the same metropolitan area were used to supply several services. Sometimes the suburb has profited at the expense of the city and sometimes the reverse seems to have been true. The former has occurred where wealthy residents have moved to the suburbs, thus depleting the property tax base of the city from which they draw their incomes and from which they continue to receive considerable benefits. Some wealthy residential districts (such as Beverly Hills

[50] Leverett S. Lyon, "Economic Problems of American Cities," American Economic Review Supplement, vol. XXXII, No. 1, March 1942, p. 309.

within the city of Los Angeles, and Brookline, adjacent to Boston) or industrial areas with valuable business properties (such as Hamtramck within the city of Detroit) are escaping their share of general costs, notably for welfare purposes, by separate incorporation. It is said that from 30 to 50 percent of the residential land in the typical American city suffers from blight, usually caused in large part by suburban migration.[51] In addition "the withdrawal from the city of many of the brains and voices best suited to help it help itself" deprives the city of a vital resource.[52] A migration or other suburban recruitment of a relatively poor population from the city may benefit the city in that more services are required by the peripheral settlement than the city rate on the property of the new suburb would provide. The suburb in both cases is likely to contribute something to the city through some trade in the latter.

City planners are by no means agreed as to whether the movement of population to the periphery is desirable. Those who think not point out that the more effective use of land within a city could provide all the space, light, and air required for its present residents. On the other hand, improvement in transportation facilities tends to stimulate the movement. Under these circumstances, consolidation of metropolitan areas can be clearly recommended but it is very difficult to achieve politically.

The States have shown little interest in the development of urban political areas corresponding with economic areas. But the Federal Government finds itself in a position to exert some pressure upon municipalities in this respect. For example, the Federal Government might well insist on an adequate municipal unit as a feature of its extension of aids, such as those for housing. The difficulty with this remedy is that the suburbs, which have no need for low-cost housing, may not be willing to combine. In the case of metropolitan areas extending across State lines, the use of even a metropolitan district would require an interstate compact. Some mechanism by which wealthy suburbs could provide themselves with superior public services at special expense to themselves would facilitate consolidation. Clearly this reorganization of municipal units is a problem which admits of no easy solution. Frequently it is selfish and vested interests which block consolidation, and pressure from central governments is fully justified in the interest of the vast majority of people concerned.

3. EXPERIENCE OF PHILADELPHIA AND NEW YORK

The experience of one or two large cities with fiscal problems during recent years should prove enlightening. That of Philadelphia and New York is especially illuminating for it is these two urban centers that have broadened their tax systems with sources hitherto thought to be reserved for central governments.

The thirties were a period of great financial distress for Philadelphia. A collapse of real-estate values in that city resulted in a 25-percent decline from the 1931 peak of assessed value of real property and a loss to the city treasury of $20 millions annually.[53] This resulted in

[51] Public Land Acquisition in a National Land-Use Program, pt. II Urban Lands, Report of the Land Committee to the National Resources Planning Board, February 1942.
[52] Leverett S. Lyon, op. cit., p. 313.
[53] Edward W. Carter and Edward B. Shils, "Philadelphia's Earned Income Tax," American Political Science Review, April 1940, vol. 34, No. 2, pp. 311-316.

heavy current deficits and temporary loans; the shortchanging of sinking funds through excessive valuation of their assets; and actual and threatened curtailment of essential services and reduction in personnel. By 1938, the city had borrowed $40 millions in excess of its constitutional debt limit. A 2-percent city sales tax enacted in 1938 encountered such strong opposition that it was rejected the next year, after 10 months' trial. The consensus seemed to be that the city was too vulnerable to trade diversion to make a local sales tax desirable. The alternative accepted was an earned income tax on income earned in Philadelphia whether by residents or nonresidents. The rate was flat but in the original law some deductions were permitted, and what amounted to a personal exemption was added in the form of a $15 allowance for the cost of filing. However, the latter allowance, in effect a personal exemption of $1,000, was ruled out by the Pennsylvania Supreme Court as a violation of the uniformity clause of the State constitution.[54] The tax encountered strong opposition and was repealed in 1939. But the financial troubles of the city again became critical and the tax was reenacted. As applied in the second attempt, the rate was 1½ percent and the profits of unincorporated business and the professions were included in the base. Corporations were excluded on the theory that because they were taxed by the State, the municipality could not tax them further. On the same theory, dividends and interest were excluded. The tax was collected so far as possible at the source and the costs were said to be quite reasonable. The yield in 1940 was $16,283,820,[55] and a very substantial rise was predicted as a result of war pay-roll increases. In the first 6 months of 1942, collections were $14,578,000.[56]

It is not very difficult to pick flaws in the Philadelphia special tax. The failure to provide a personal credit, and the exemption of dividends and interest can be justified only on legal grounds. These features give the tax a considerably regressive character.

During the early thirties, New York City also found itself in acute financial distress. Whether or not the trouble was due chiefly to "decades of Tammany rule" as alleged, existing revenue sources were financially or politically unavailable for new funds. The city was spending $240 millions annually for relief, one-quarter of which was locally provided. In 1933, $70 millions were borrowed for relief, a sum which was exhausted in 14 months. The city was said to be more or less the pawn of the banking syndicate which had been supporting its credit and the sales tax was the only prospective new source of revenue that the bankers approved of as sufficient to meet the needs. Accordingly, a retail sales tax was accepted by Mayor LaGuardia, erstwhile opponent of the sales tax in Congress, as the only available alternative. An income tax was passed, but repealed before collected. A transit tax was opposed by retailers as inimical to their business. The merchants also opposed the sales tax but had no plausible alternative to offer. Organized labor was appeased by the exemption of food and offered little opposition, referring to the tax as "a contribution to relief." Special enabling legislation allowed action by the city for a limited period, since extended, and a sales tax went into effect in New York City, December 10, 1934.

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[54] *Butcher* v. *City of Philadelphia* (333 Pa. 497).

[55] Edward W. Carter and Edward B. Shils, "Philadelphia's First Year of Earned Income Tax," National Municipal Review, vol. 30, No. 8, August 1941, pp. 482-487.

[56] Tax Policy, August 1942, p. 4.

The then Aldermanic President Deutsch made a reluctant case for the tax as follows:

> We were confronted with a situation which admitted of no delay, and where the consequences of delay would have been so disastrous and tragic that no tax, however savage or however unfair, could possibly have been as serious.[57]

The tax was an immediate fiscal success, supplying New York City with about $48 millions of much needed revenue. Administrative costs were moderate, though it is said that relatively little concern was manifested over considerable evasion, particularly by the small merchant. Strenuous efforts were made to popularize the law. Every placard and advertisement mentioning the sales tax carried with it an announcement of the purpose of the tax. An advisory Council on Taxes for the Relief of the Unemployed, consisting of prominent citizens, was created to suggest amendments and to mollify critics. In sum, there was a planned and sustained effort to create good will and to avoid frictions, which might imperil future collections.

Goods bought in the city for delivery outside are not taxed. The suburban shoppers are thereby encouraged to continue buying from their accustomed stores. On the other hand, a personal property tax, with a rate equal to that of the sales tax, has been imposed upon a given list of articles bought outside the city but consumed within it. Residents of New York City are thereby discouraged from transferring their patronage to nontaxed regions. The personal property tax is enforced on large visible items only, mostly pianos and automobiles, and fails very largely to perform the function of a tariff, whether protective or for revenue. An attempt to prove that the retail business of New York suffered as a result of the law has been made [58] but the evidence on the point is not at all conclusive.

The New York City experience with a special independent source of revenue has been reasonably satisfactory but it is not difficult to criticize. The earmarking of the funds for relief proved to be good salesmanship but the accounting is confused and such procedure should be confined to cases of special benefit from a tax. The tax was no less a sales tax because of this earmarking. The administrative and jurisdictional problems and effects on business usually associated with the local use of sales taxes have apparently been quite prominent in New York.

The tax was justified, perhaps, as the only available alternative but the experience will remain for many years a most striking example of the inadequacy of the local revenue system.

Studies of the finances of New York City show that the Federal and State Governments collect substantially more taxes in New York City than the city does for its own purposes.[59] One calculation estimates that in 1942 the city's share of total collections will run as low as 25 percent. This is partly accounted for by the fact that, while some of the largest corporations do business all over the country, their incomes and capital stock are reported by their central offices located in New York City. Similarly, various excises that apply to nation-wide sales are paid in New York. It is nevertheless true that the taxpaying ability of New York's own resident and working popula-

[57] New York Times, November 29, 1934, p. 31.

[58] Study of department store sales figures, statement issued by the National Retail Dry Goods Association, New York Times, February 1, 1935, p. 39.

[59] This and the next two paragraphs are based on Edwin H. Spengler, Preliminary Report on Urban Financing.

tion, its local property owners, and its consumers is, on a per capita basis, far above the average for the country.

In 1938, Federal and State grants and expenditures constituted more than one-third of total governmental cost payments in New York City (excluding capital outlays of the municipality) and Federal payments resulted in extensive physical construction that otherwise might never have been undertaken.

Assessed valuations in New York City slumped from a record $20,073 millions in 1931 to $16,641 millions in 1940. This reversed a persistent and sometimes very rapid trend upward, and, added to tax delinquency and an upward trend in the demand for services, produced the city's financial crises. A rising tax rate was insufficient to compensate for these other trends.

4. RECASTING THE GENERAL PROPERTY TAX

A major cause of the failure of municipal revenues on the score of adequacy is the unpopular general property tax. Although this tax proved the mainstay of local support for many years, it broke down badly during the recent depression and is under incessant political attack, by State and local leaders. The property tax, like the income tax, is attacked because its base is too narrow. The property-owning lower middle class resent what they regard as the tax-free status of the proletariat. This attack gains strength because of the traditional interest in widespread ownership—particularly home ownership. Finally, the property tax is resented because of its regressivity, the fact that it falls with greatest weight on relatively poor taxpayers.

The Urbanism Committee reported [60] that the statistics for seven typical large cities show that the average urban property owner pays but slightly more in the form of property taxes for both State and local governments than he does for electricity, gas, and telephone charges. But the limitations are political as well as economic; property taxpayers are far better organized now than ever before and their resistance to higher property taxes will be a force to be reckoned with in the future.

The narrow jurisdiction of the municipality makes it essential to depend on a relatively immobile tax base for the major part of local revenues, and this points to the continuance of the largest part of the local tax burden on real estate. But there are important possibilities of redistributing this burden among individual owners of real estate and their tenants.

What is needed apparently is some new source of local revenue which will (1) not overlap existing Federal and State taxes, (2) enable the localities to tap their own resources without running hat in hand to central governments, (3) cover all or a vast majority of the interested citizenry, and (4) not be regressive. This is no easy assignment but the following suggestions are recommended for consideration.

The property tax might well be broken down into its elements and its uniform application to all owners on the basis of holdings be abandoned. One way of recasting the fragments would contemplate a collection from landlords in the nature of a service charge for local benefits to property, and a further collection, more personal in character, from occupants on their rental value of occupancy. The

[60] Urban Government, p. 23.

occupancy tax could be added as either a replacement or a supplement to the general property tax; and it might be introduced step by step on a gradual and experimental basis.

The property tax has suffered from notoriously weak administration. But the best possible assessment would fail to overcome the shortcoming of market value as a measure of taxpaying ability. It may be conceded that the owner of real estate producing no current income has some taxpaying ability. But it may still prove awkward to obtain the necessary cash for tax payments; and more important, the expected future income on which the market value is based may never be realized.

In view of these limitations a good case can be made for shifting a part of the burden to current income from real estate, that is, the gross rental value of occupied premises. It may not be desirable to reduce current levies, in view of the fact that these may be partly capitalized, and that there is no certainty that the owner would reduce rentals to his tenants if such a change were made. At least where there is need for more municipal revenue, a city might well give consideration to a tax on rentals, collected from the occupant. One advantage of such a tax is that, being in proportion to current income rather than expected future income, it would spread the burden over the various parcels of real estate in a different manner from the tax on capital values. Unused properties would be exempt. Also, the distribution between tenants and landlords would vary, since there is always some friction in the process of shifting. The occupant's tax would not avoid problems of migration and administration but it would probably encounter less difficulties in these respects than a local income tax. Finally a rental tax could make some allowances for individual ability to pay. The tax on home rentals might be adjusted to take account of size of family, and a progressive rate might be imposed. This would tend to offset the regressive tax on capital values. The progressive rate would be supported also by the fact that the proportion of income spent for rent tends to decrease as incomes become larger. A business rental tax would, of course, be levied at a flat rate.

Among the objections to a supplementary rental value tax would be the necessity for two valuations—rental value as well as capital value. This is not a simple problem, since many properties are occupied by their owners, and in other cases the actual rent paid must be adjusted to allow for special circumstances.

There are other objections to a rental tax. For instance, it would offer no answer (except in its possible graduation feature) to the criticism that much of the weight of the local tax system falls on housing, an area of expenditure in which the nation is trying to improve standards. Some concessions to housing, probably confined to the philanthropic element in public housing, would probably be necessary. It is quite possible, too, that an occupancy tax might increase the cyclical fluctuations in city revenues. Nevertheless, the frequency with which such taxes have been used by other countries suggests that they have possibilities that may well be explored.

Other ways of reaching the property base are the use of unearned increment taxes and the further development of special assessments. The latter have sometimes been used to excess, and the record of administration is not encouraging, but many cities have failed to develop their possibilities adequately. Many municipal services yield special benefits, and the cost might reasonably be covered in this way. Some municipalities could revise their public-utility charges, also, to cover costs, or even to contribute to the general treasury.

In any event, the municipality should be given greater freedom in the application of the general property tax. Rate limitations offer no constructive solution to the problem of financing local government or improving the property tax.[61] The right of the cities to tax their own citizens as they please within the property-tax area, primarily suited for local exploitation, should be generally restored, subject only to rules supplied by the State as to the general framework. Administrative assistance from the central units need not be precluded by such a development.

Much of the dissatisfaction with the property tax has come from inequalities in the tax burden, which have resulted in excessive levies on individual properties when the average levy was not unreasonable, and which have made the tax an easy target for any discontented taxpayer. These inequalities have arisen from tax exemptions, failure to assess all real estate equally at its market value, and the failure of market values to reflect either the current year's income or the capitalized value of future income.

The remedy for tax exemption is obvious. It is not, of course, feasible to return all exempt property to the tax rolls overnight. But it should be possible to resist pressure to extend full exemptions to low-cost housing projects, homesteads, and other new candidates for exemption in the future. It should be possible, also, to interpret existing provisions for exemption more strictly, denying the privilege to border-line cases—properties belonging to organizations whose claims to exemption are not altogether clear. And the municipality that is using exemption (perhaps illegally) to attract new enterprises can mend its ways. The State can assist in limiting the permissible exemptions, and both Federal and State Governments can submit their own properties to taxation (with the necessary safeguards) when such properties are an important part of local real estate.

Improved assessments probably offer even greater possibilities than decreased exemptions for spreading the tax burden more equitably in most cities. The tendency to favor new building and new industry by low assessments, and to freeze assessments in the older and blighted areas, where market values are declining, is partly responsible for the regressiveness of the tax on real estate. Effective State supervision, or State assessment, if such central assistance cannot be developed, is needed to offset the pressure of special local interests. Even left to their own initiative, some cities have been able to achieve a satisfactory assessment.

In this report it has not been feasible to cover many of the numerous problems of State-local fiscal relations. But it seems in order here to comment that nowhere do fiscal relations offer a greater opportunity for improvement than in those of the States and localities involved in the administration of the property tax. In cooperativeness of attitude, adequacy of assistance, and techniques of procedure, im-

[61] "Their avowed purpose is to create a fiscal crisis and a resort to any action other than an immediate increase in real estate taxes." George Mitchell, The Property Tax, unpublished manuscript prepared for this study.

provements of revolutionary proportions are possible and imperative. Even the Federal Government has proved helpful in this field in some States, as in Pennsylvania, where George-Dean Act appropriations have been used to develop scientific assessment data.

The widely prevailing notion that the general property tax, except for new exemptions and rate limitations, is a crystallized institution and fixed for all time should be exploded. Whether or not these specific proposals are received with favor, the whole subject of independent local revenues should be given fresh and bold reconsideration.

5. OTHER SOURCES OF FINANCIAL SUPPORT FOR MUNICIPALITIES

The Federal Government is in the best strategic position to cope with cyclical emergencies and should, even with the strengthening of local financial independence, continue to finance employment-creating improvements during such periods. There is much to be said for a cyclical budget for cities and some of them have been forced to such procedure by the depression tide of tax delinquency. But cyclical financing, though in accord with national fiscal objectives, often encounters the impediment of inflexible local debt structures. Moreover, the business cycle is a quite unpredictable phenomenon.

As elaborated elsewhere, the Federal Government should enlarge the area of functions to which it contributes support through grants-in-aid. This, of course, will provide some financial relief for cities. Confidence in Federal aid, as the major source of new fiscal support for municipalities, was expressed by A. M. Hillhouse:

> The real financial hope of the cities, however, lies in the further extension of grants-in-aid and city-sharing in centrally collected taxes.[62]

On the other hand, the following excellent statement shows that there are pitfalls and limitations also in this direction:

> I know of nothing more important to the continuance of self-government in this country of vast areas and regional variances than the widespread education and training which comes from the local responsibility in thousands of communities for making and balancing budgets, planning current and long-term requirements and the means of managing them and paying for them, and accounting for them and reporting on them in ways that develop local interest and pride. To have our municipalities become merely the adjuncts of a centralized national system would destroy our best training ground for public leadership, curtail the flexibility which we now have for practical experimentation in administrative methods, and eliminate the best opportunity we have for developing the civic responsibility that is necessary to keep democratic government a going concern.
>
> The majority of our cities are fairly well managed and are demonstrating their ability to stand on their feet financially for all normal requirements and for moderate emergency requirements. The best managed of our cities are ahead of the Federal Government in the quality of their administration. Yet this generally encouraging situation is likely to be overshadowed by the cries for help which come from a minority of cities which either have failed to measure up to a minimum standard of good financial management or prefer to take the easy way of securing Federal aid without counting the ultimate consequences.[63]

It should be noted that reliance upon shared taxes as a source of local support involves a considerable sacrifice of local fiscal independence. In addition to the revocability of such sources at the discretion of the State, the latter controls the scheme of apportionment and may tie strings to local expenditure of the funds.

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[62] A. M. Hillhouse, New Sources of Municipal Revenue, p. 3.

[63] Letter to authors from Frederick Bird.

The amount of locally shared revenue which must be used for certain purposes has also increased from $159,907,000 or 61.2 percent of all State-administered locally shared taxes, in 1928, to $293,184,000 or 62.7 percent of all shared taxes in 1938.[64]

Federal payments in lieu of property taxes on Federal-owned property, such as housing, should be more generous and dependable.

While the retail sales tax as a local revenue source is quite objectionable because of its overlapping of central sources, its regressivity and its jurisdictional complications, it may, nevertheless, be worth considering as a last resort. Exemption of food might reduce regressivity and some city might test the practicability of a personal exemption under this form of tax. As against the steady and extensive surrender of local fiscal independence, the city sales tax might merit further consideration.

The major need is for a source of revenue which will enable the municipalities to tax their own resources independently. Much of the vitality of local government in the United States depends upon the discovery and utilization of such a source.[65]

6. REVENUE PROBLEMS OF LOCAL GOVERNMENTAL UNITS OTHER THAN CITIES

The impression should not be left that revenue problems of municipalities are confined to cities. Rural property owners in the early thirties presented a picture of very great distress; taxes had increased in the twenties, farm income was drastically reduced, and farm values were also much depressed. The State-aid and shared-tax programs and the assumption of highway costs by larger units of government have in many cases given rural taxpayers substantial tax relief. With improved farm income during the war period, the property-tax load rests much more lightly on the average rural taxpayer than it has for many years. Another wave of depression might bring back some of the property-tax pressures with which farms are quite familiar. The claim of the raw material producing areas that they receive an inequitable share of the national income has a bearing on this matter.

Depleted and under-endowed areas also have a place in the property-tax problem. These communities have usually been the recipients of large amounts of State and Federal aid without which they could not have maintained even a semblance of decent standards of public services. These areas are a problem to the State as to land use, the reorganization of local government, and the perpetuation of obsolete communities.

The property-tax problem of depleted and under-endowed areas is fundamentally different from that of the cities. The former suffer because of inadequacy of the resources with which to support government, the latter because of the inability to tax usually ample resources. The fiscally weak communities can be assisted by central governments, principally through grants-in-aid. Some reorganization of governmental machinery, attending or preceding the grant program, can also be recommended.

[64] Ralph R. Teeple, The Shared-Tax Device in State-Local Relations, abridgement of a doctoral dissertation, New York University, unpublished, 1942, p. 10.

[65] Urban Government, p. 4. (The Urbanism Committee recommended an intergovernmental budget commission representing Federal Government, States, and cities. It was proposed that the commission deal with problems of allocating revenues and with possibilities of collaboration in the administration of overlapping taxes. This closely resembles the recommendations made by many other students of intergovernmental relations. It is discussed elsewhere in this report and the recommendation of the Urbanism committee, with some modifications, is endorsed.)

PART 3

SPECIFIC TAXES AND EXPENDITURES

CHAPTER VII

SPECIFIC TAXES

(Income, Business, and Death Taxes)

A. Net Income Taxes[1]

1. INTRODUCTION

(a) *Importance of coordination in the income-tax field.*

Coordination in Federal and State income taxation is of first importance, for it is in this field that multiple taxation (threatened and perhaps actual), interstate migration to avoid taxes, and high compliance costs are particularly prominent.

The Federal Government developed this field as one for permanent exploitation only after 1913. Since then, however, the tax has become a mainstay of Federal support. For many years, the Federal Government abstained from all taxation in the lower brackets of income and imposed relatively mild rates on the lower-middle and middle brackets. Even as late as the Revenue Act of 1939, a married man with two dependents paid as little as $61.20 on a $5,000 income. This policy was partly for the purpose of leaving a field for State taxation. More recently the Federal Government has begun to plow its potential income-tax field considerably more extensively, and much more intensively. Exemptions have been reduced, and heavy rates on even the lowest brackets of taxable income have been imposed. While this change in policy may be for the emergency only, it seems more likely that demands for more adequate revenue will insure its permanence. Improved administrative techniques, particularly collection at the source, will probably be developed to facilitate this change of policy.

The State income taxes are of early origin, but the modern effectively administered tax was first applied in Wisconsin in 1911. The use of this tax developed slowly at first, but it is now found in about two-thirds of the States. However, many of the more populous and industrialized States—for instance, Illinois, Indiana Michigan, Ohio, Pennsylvania, and New Jersey—are still outside these ranks. Owing mostly, perhaps, to factors of interstate competition, the income-tax field has not been intensively tilled by the States. But the potentialities of further development are considerable and the problems of coordination, as stated above, are very substantial.

The coordination problem in the income-tax field is of particular interest at the present time because of recent events in Australia and Canada. These are referred to in an earlier section, but it may be in order to describe them here in greater detail.

[1] Based mainly upon a monograph prepared for this study: Herbert Klarman, Personal and Business Net Income Taxation in the States.

(*b*) *Experience of Australia.*

In Australia, the Federal Government entered the income-tax field in 1915. Up to that time the six States had preempted the field.[2]

Australia's income-tax experience is noted for several innovations, e. g., the vanishing personal exemption,[3] treating the wife like any other dependent for exemption purposes,[4] the minutely graduated tax-rate structure,[5] separate schedules for earned and property income,[6] State administration of Federal taxes and vice versa,[7] and the partnership method of taxing the undistributed income of closely held corporations.[8]

For present purposes, two aspects are especially noteworthy; namely, the State administration of Federal taxes, and the prevailing interstate taxpayer differentials.

In 1915, when the Commonwealth Government found it desirable to invade the income-tax field, all six States already had income taxes. The resulting duplication in administration appeared with dramatic suddenness, and the taxpayers objected strenuously.[9]

In one State, Western Australia, the State hired the Federal Government to administer virtually its entire revenue system, beginning in 1920. In the other 5 States, the Federal Government farmed out in 1923 the greater part of the Federal income tax for administration by State officials who act simultaneously as Federal deputies at cost.[10] Taxpayers with interstate sources of income are assessed by the Federal Government.[11]

The existence of an amalgamated administration has facilitated the movement toward uniformity of the tax statutes of the various jurisdictions.[12] Also, a great deal of informal cooperation exists among the tax commissioners. For instance, the tax commissioner of a State in which an interstate corporation has its head office assesses the corporation and sends out transcripts to the commissioners of the other States, which include even a report on the percentage of total income that the corporation claims to have earned in each State.[13] At the same time, each jurisdiction has retained freedom of action regarding rates, exemptions, capital gains, and special favors to industry.[14]

Professor Haig lists the following results of amalgamation:[15] (1) Savings in costs of administration; (2) reduced costs of taxpayer compliance; (3) uniformity in statutes; (4) less evasion; (5) less discriminatory double taxation.

On the whole, the Australian experiment in amalgamated administration appears to have been successful. However, most of those who have studied the Australian experience do not suggest that the United States adopt the same plan. Rather, they recommend for this country

[2] H. S. Carslaw, "Federal and State Income Tax," Economic Record, vol. 17, p. 20, June 1941.

[3] Ibid.

[4] Joseph H. Barkmeier, "Income and Excess Profits Taxes in Australia," International Reference Service, U. S. Department of Commerce, vol. I, No. 41, July 1941, p. 5.

[5] Carslaw, op. cit., p. 20.

[6] Barkmeier, op. cit., p. 11.

[7] Robert M. Haig, "Amalgamated Federal-State Tax Administration in Australia," Proceedings of the National Tax Association, 1937, p. 373.

[8] Robert M. Haig, chairman, "Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations," Proceedings of the National Tax Association, 1939, p. 548. Also Barkmeier, op. cit., p. 7.

[9] Haig, "Amalgamated Federal-State Tax Administration in Australia," p. 373.

[10] Ibid., p. 373. For fiscal year 1939, the State income taxes produced a yield of £30 million while the Federal income taxes produced only £12 million (Carslaw, op. cit., p. 22). The revenue superiority of the State may account for the resort to State administration of the Federal income tax.

[11] Ibid., p. 374.

[12] Ibid., p. 375. Substantial uniformity has been achieved in the allocation of interstate corporate income.

[13] Ibid., p. 376.

[14] Ibid., p. 375.

[15] Ibid., p. 380.

the establishment of a small joint Federal-State board with the single and specific purpose of administering the Federal income tax and the income taxes of such States as might care to take advantage of its services. They believe that such an arrangement can be initiated if only one or two important States desire to cooperate. The other States will tend to follow.[16]

Unitary administration is no guaranty of uniform tax burdens in the several States, if each jurisdiction reserves complete freedom of action over rates. An article on the Australian Federal and State income tax paraphrases, in part, a speech by the Treasurer of the Commonwealth on the consequences of such freedom of action.[17]

The Treasurer (Mr. Fadden) told Parliament that the rates imposed by the States had very considerably hampered Commonwealth taxation, and that it was a matter for consideration whether under the increasing pressure of war the present position could continue. The difficulty arose at all points of the scale, but chiefly at the lower and higher ends.

The wages tax and other State taxes on income down to quite a low level differ in the different States. An even more pronounced lack of uniformity exists in the way the States treat high incomes. The Commonwealth cannot discriminate in its rates between the States. It follows that its tax must press more heavily under present conditions on wages and low incomes in some States than in others, and that the heavy taxation on large incomes in Queensland compels the Treasurer to let off too easily many large incomes, say, in Victoria.

In effect, the Treasurer alleged that the heavy taxes in the one State of Queensland prevented the Federal Government from raising its own rates on high incomes. Instead, it was forced to rely on steep graduation, ceasing at a fairly low income level.[18] The Treasurer therefore suggested that the States surrender the use of the income tax for the duration of the war, with appropriate reimbursement by the Commonwealth.

The relative scarcity of information on the Australian tax situation renders it difficult to form an intelligent opinion as to whether the Treasurer's request was justified. Since the Commonwealth allows the deduction of State income taxes in computing the tax base for Federal purposes, it would appear, in the light of the analysis later presented, that the interstate taxpayer differentials in Australia should be quite small, whether or not the States reciprocate with deductibility of Federal income taxes.[19] Since, however, the Treasurer made the urgent request that the States abandon the income tax, the most plausible explanation is that deductibility did not operate in a congenial environment.

Deductibility is most "effective" throughout the income scale when one rate stucture is high, and the other is low.[20] Of secondary importance, but also helpful, are steep progression and graduation by income brackets in both structures. The Australian Commonwealth

[16] Ibid., p. 379.
[17] Carslaw, op. cit., p. 22.
[18] Carslaw, op. cit., p. 25.
[19] New South Wales and Victoria, the most important States, do not allow deductibility. Barkmeier, op. cit., p. 5. Data on the other States are not accessible.
[20] The statement is based on hypothetical calculations (Herbert Klarman, Personal and Business Net Income Taxation in the States, monograph prepared for this study).

rates, which now attain a maximum of 83⅓ percent, were formerly relatively low, reaching a maximum of 50 percent in 1940. While the graduation was and still is steep, now ceasing at a low level of income, $10,000,[21] it rises under each pound of income,[22] thus applying a lower effective rate to the tax deduction than under a bracket system. The State tax rates are higher, on the whole, in Australia than in this country. Victoria ranks lowest, with a maximum rate of only 9.06 percent on earned income; but this rate applies to every dollar of taxable income, if income exceeds $40,000 (£10,000).[23] The New South Wales rates reach a peak of 23 percent,[24] and while the exact Queensland rates are not available, their maximum is known to be considerably in excess of 25 percent.[25] The combination of a Federal tax rate of 50 percent with a State rate of 30 percent would, under unilateral deductibility, yield a combined effective rate of 65 percent. Since the corresponding combined effective rate in Victoria would be 54.5 percent, the tax differential between residents of Victoria and Queensland would be 10.5 percent. If the Queensland rate is 40 percent, the tax differential [26] becomes 15.5 percent. Under the new Commonwealth rates of 83.3 percent, the maximum differentials under unilateral deductibility are 3.5 and 5.2 percent, when the Queensland maximum tax rates are 30 and 40 percent, respectively. It appears that sizable differentials in the effective rates of tax existed in Australia among residents of the several States before the high rates of 1941 were enacted, and might conceivably have furnished the basis for the movement to eliminate the State income taxes.

The States were asked to discontinue their income taxes for the period of the war, and legislation to that end has passed Parliament and has been approved by the Court. Suspension of State income taxes has been accompanied by (1) transfer to the Commonwealth of State administrative machinery and staffs; (2) an increase in Commonwealth rates corresponding to an "average" State schedule; and (3) provision of grants to the States.

(c) *Canada.*

The Dominion of Canada imposed direct taxes for the first time when it adopted the income tax in 1917. At that time only three of the nine Provinces had income taxes (British Columbia and Prince Edward Island, provincial, and Nova Scotia, municipal).[27] In recent

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[21] The sum of $10,000 refers to £2,500, where graduation ceases on the "personal exertion" rate scale. On the "property" rate scale, the limit of graduation is now £2,000.

[22] The Australian rate structure is a positively sloped straight line, with constant differences in rates between each pound of income. The straight line or arithmetic progression represents a gain in equity and is conceptually simple, but requires complex mathematical manipulation by the taxpayer.

[23] Barkmeier, op. cit., p. 12.

[24] Ibid.

[25] Carslaw, op. cit., p. 26.

[26] In the present context, the tax differential signifies the difference in tax liability between a resident of a given State and a resident of Victoria, the State with the lowest income tax. For an analysis of how deductibility affects tax differentials see the discussion on p. 437ff.

[27] The actual distribution of power between the Dominion and the Provinces resembles that between the Federal Government of the United States and the several States, although on the face they are quite different. By the British North American Act, analogous to the Constitution of the United States, the Federal Government was given the power to legislate on about 29 specific subjects and also a general residual power "to make laws for the peace, order, and good government of Canada," about all matters "not assigned exclusively to the legislatures of the Provinces." While the Canadian Constitution grants the residual power to the Dominion, judicial interpretation has so whittled it away, that it appears now that the Provincial power to legislate about "property and civil rights" is the real residual power (J. A. Maxwell, Discussion of Intergovernmental Fiscal Relationships, Proceedings of the National Tax Association, 1940, pp. 218-219). The result of this reshuffling of powers has been that most of the new expensive functions of the Government have been allocated to the Provinces, resulting in the severe need for funds by the Provinces and their adoption of the income tax (R. M. Fowler, "Inter-Governmental Fiscal Relations in Canada," Proceedings of the National Tax Association, 1940, p. 208). The Dominion has more or less respected the predicament of the Provinces and has been reluctant, at first to invade, and then to exploit, the field of direct taxation, since this was the source of most Provincial revenues (Stuart S. Garson, "The Effects of the War Upon the Canadian Provincial Fiscal Systems," Proceedings of the National Tax Association, 1941, pp. 59-60).

years all the Provinces have entered the field,[28] thus giving gradual rise to Dominion-Provincial conflicts in this area. Apparently the situation became quite serious, especially in the field of corporate taxation, for in 1940 the Royal Commission on Dominion-Provincial Relations [29] recommended, among other measures, the retirement of the Provinces from the fields of personal income tax, corporation tax, and the inheritance tax, in return for compensation. The opposition of some of the Provinces prevented immediate action but the war forced the Dominion to disregard Provincial objections and to set the rates of its personal and corporation income taxes at the maximum level possible. And the Provinces have agreed, as a temporary measure, to abandon their own income taxes in return for grants that fully compensate them for lost revenues.

Before the retirement of the Provinces from the income-tax field for the duration, four of them [30] had entrusted the administration of the income tax to the Dominion.

In the case of these Provinces the same officers, organization, income-tax forms, notices, and returns of the taxpayer were utilized both for the Dominion and the Provincial taxes. Thus in Ontario, for example, the taxpayer filed only one return and dealt with only one "inspector's office." He received one "notice of assessment" specifying separately the Dominion and the Provincial income taxes. He made payment to one office and received one receipt.[31] In general, the Provincial systems were closely analogous to the Dominion income tax.[32] This facilitated the use of a single return for both taxes.

Income taxes paid to the Provinces did not constitute a deductible expense under the Dominion law. While three Provinces, Ontario, Prince Edward Island, and Manitoba, allowed the Dominion income tax to be deducted from the Provincial tax base as a concession to the taxpayer, they did not thereby succeed in substantially reducing interstate taxpayer differentials. The main reason is that the rate structures of the Provinces not permitting deductions were, on the whole, just as high as those of the Provinces permitting deductions.[33] In fact, under the 1941 Dominion maximum rates of 85 percent, the combination of Federal and Provincial taxes would have confiscated the income above certain brackets in three of the Provinces not permitting deductions and almost confiscated it in the fourth.[34]

2. DIVERSITIES IN STATE LAWS

(a) *Dividends.*

Diversity of State income taxes in the United States is quite substantial. One of the major points of difference is in the treatment of dividends. There is less diversity in the treatment of stock dividends

[28] New Brunswick and Nova Scotia income taxes on individuals are municipal.

[29] Report of the Royal Commission on Dominion-Provincial Relations, Ottawa, 1940.

[30] Ontario (1936), Manitoba (1937), Prince Edward Island (1937), and Quebec (1939). Figures in parentheses indicate dates of initiation of Dominion administration.

[31] Commerce Clearing House, Canadian Tax Service, vol. 1, New York, 1941, p. 902 (par. 10-007).

[32] Ibid., p. 902 (par. 10-607). "In fact the acts of Alberta, Manitoba, Ontario, Prince Edward Island, Quebec, and Saskatchewan are modeled on the Dominion Act. Even the act of British Columbia, which has a history of its own, antedating that of the Dominion by many years, is very similar. Consequently, a determination of taxable income for Dominion purposes is usually accepted for Provincial purposes."

[33] The maximum rates in the Provinces permitting deductions are: Ontario, 28 percent; Prince Edward Island, 10 percent; Manitoba, 50 percent.

[34] The maximum rates in the Provinces not permitting deductions were: Alberta, 31 percent; British Columbia, 28 percent; Quebec, 12 percent; Saskatchewan, 37 percent. The combined maximum Dominion and provincial rates were: Alberta, 116 percent; British Columbia, 113 percent; Quebec, 97 percent; Saskatchewan, 122 percent. The addition of the National Defense Tax of 5 percent renders all four combinations confiscatory. It will be noted, furthermore, that the municipal income taxes levied in Montreal and in municipalities of the three Maritime Provinces have not been taken into consideration.

than of cash dividends. For the former, an overwhelming majority of the States follow Federal leadership and do not include stock dividends in income. Only five States subject stock dividends to taxation—North Dakota, Oklahoma, Oregon, South Carolina, and Vermont.

The treatment of cash dividends is more varied, ranging from exemption—which may take the form of an exclusion, a deduction, or a credit—to additional taxation. With minor qualifications, eight States exclude dividends from individual gross income to the extent that they are paid out of the income of corporations already taxed by them. Three States, Iowa, Missouri, and South Dakota, aim at a similar but more equitable result by allowing a credit equal to the amount of the corporation tax on dividends paid out of taxed corporate income. Since the first two apply a flat rate to corporate income, they state the credit in terms of that rate. Four States, Alabama, Arizona, Idaho, and Wisconsin, employ the so-called "50–50 rule," whereby such dividends as are derived from corporations earning more than 50 percent of their income in the taxing State are entirely deducted from the income of the individual taxpayer. Seventeen States, including three that do not impose a corporation tax, tax dividends fully, like other income. With the exception of Vermont, all States levying both personal income taxes and corporation franchise taxes measured by net income, as distinct from direct income taxes on corporations, fall into this group. Finally, two States, Colorado and Oregon, impose surtaxes on dividends, in addition to including them in full, like other income, under the regular income tax.

The varying treatment of dividends in the State income-tax statutes may be associated with corresponding conceptions of the relation between corporation and individual income taxes.

(*b*) *Interest from local, State, and Federal securities.*

All personal income-tax States now exempt the interest from obligations of the United States; on the other hand, all tax the income from obligations of other States and their political subdivisions. With respect to the income from obligations of the home State, the treatment varies: 9 tax it, 24 exempt it. In addition, 3 more States, or 12 in all, tax the interest from the obligations of the political subdivisions of the home State.

The treatment of the interest from Federal obligations under the State corporation-income taxes also shows considerable diversity. Nine of the eleven States that levy corporate franchise taxes measured by net income [35] tax Federal interest. All the remaining 21 States which impose direct income taxes exempt such interest. Fifteen of the States tax the interest on their own obligations. This number includes all but one [36] of the 9 States which both levy corporate franchise taxes and tax Federal interest and all the States which tax the interest from their own obligations under the individual income taxes.[37] Sixteen States, the above 15 and Virginia, also tax the interest from the obligations of their political subdivisions. All but

[35] California, Connecticut, Massachusetts, Minnesota, Montana, New York, Oregon, Tennessee, Utah, Pennsylvania, and Vermont do not tax the income from Federal bonds. Federal interest is taxed in California and Minnesota under the franchise tax; it is exempt under the direct income tax.

[36] Tennessee.

[37] Colorado, Idaho, Iowa, Kansas, Oklahoma, South Dakota, and Wisconsin.

2 [38] of the States appear to tax the income from the obligations of other States and their subdivisions. These exceptions may be attributed to the total adoption of the Federal definition of income. Notwithstanding favorable judicial attitudes [39] toward the inclusion of interest in the base of State corporation-income taxes, 23 of the income-tax States exempt the income from the securities of the Federal Government and its agencies. With respect to the 21 States which have corporate net income taxes other than franchise taxes, the treatment of interest from Federal obligations is generally the same for corporations and individuals.

(c) *Concept of income.*

The income tax, as administered, is based essentially on an exchange concept of income. While no income-tax statute in the United States grants an explicit exemption to farmers on the consumption of home-produced commodities, ineffective administration of the statutes in this area practically achieves the same purpose. Wisconsin is the exception, including for farmers a presumptive income for food consumed of $90 for each adult, and $60 for each minor living on the farm. Wisconsin also attempted, originally, to tax the rental value of an owner-occupied home as a part of income, but later abandoned this feature.

(d) *Personal exemptions.*

All the individual-income-tax States except Tennessee grant personal exemptions. In turn, all except New Hampshire, which taxes only income from intangibles, allow a greater sum to married persons or heads of families than to single individuals.

The personal exemption is generally given as a deduction from income. However, five States, Arizona, Iowa, Minnesota, South Dakota, and Wisconsin, express the exemptions in the form of tax credits, and two more, Kentucky and Louisiana, achieve the equivalent result by having the income allowance deducted from the lowest income bracket.

Until 1940 an overwhelming majority of the States had exemptions lower than, or equal to the Federal standard of $1,000 for a single individual and $2,500 for a married person or head of family. Now only six States have exemptions that are equal to or less than the Federal level (at $750 and $1,500).

The exemption for single persons is $1,000 in 19 States. Exemptions of less than this amount, ranging from $200 in New Hampshire to $850 in Oklahoma, prevail in 9 States. In addition, 3 States grant exemptions of $1,500 and 1 State, an exemption of $2,000. One State, Tennessee, grants none.

(e) *Community property.*

The community-property provision in some State laws affects tax liability for both State and Federal purposes. This provision declares that husband and wife have a joint interest in the earnings of either, of from the property resulting from the earnings of either, after their marriage.

[38] Pennsylvania and Tennessee. The data on the latter are not clear.
[39] *Pacific Co., Ltd.*, v. *Johnson* (285 U. S. 480 (1932)).

Until recently there were eight community-property States.[40] Lately Oklahoma has enacted a similar provision, the validity of which the Bureau of Internal Revenue has thus far refused to recognize.[41] Of the other eight States, five levy State individual income taxes[42] in which cases the community-property provision, in effect, lightens both the State and the Federal income-tax burden below the effective rate generally indicated.

(*f*) *Disposition of proceeds.*

In 24 States all the collections from income taxes go to State funds, in 10 they are shared with the local units, and in 2 the entire sum is distributed to local units. Even where the collections remain with the State, the entire sum, or a portion thereof, may be earmarked for the performance of special functions, e. g., education or welfare, which elsewhere are within the province of the localities.

Over 18 percent of the total State income-tax collections of $423 millions in 1941 were distributed to the localities.[43] Massachusetts, Minnesota, New York, and Wisconsin distributed over 90 percent of this sum. Where income-tax collections are shared between the State and the localities, there has been a tendency for the portion going to the latter to decline. The localities are refused participation in new surtaxes,[44] and their share in the old taxes may be reduced by lowering the percentage of total collections distributed to them,[45] or by restricting their share to a constant percentage of that portion of the collections attributable to the old tax rates, with all the collections resulting from an increase in rates accruing to the State.[46]

(*g*) *Nominal rate structures.*

The rate structures of the State individual income taxes are all progressive. Twenty-eight States explicitly provide for progressive rates. Three States, Massachusetts, Maryland, and Vermont, vary the rate with respect to income sources, attaching a higher tax rate to investment income; two others, Tennessee and New Hampshire, tax only income from intangibles. Insofar as investment income constitutes a higher percentage of large than of small incomes[47] the exclusive taxation of such income or the imposition of a higher tax rate upon it is a rough approximation to progressive graduation. Everywhere the tax rates are applied to portions or brackets of the individual's income.

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[40] Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

[41] Probably because the Oklahoma scheme was avowedly adopted as a tax-competing and therefore tax-evasion device.

[42] Arizona, California, Idaho, Louisiana, and New Mexico.

[43] The Bureau of the Census distinguishes between "shared taxes" and "grants from specified sources." The former relate to taxes distributed substantially in proportion to the amount collected in each locality. The latter are grants from taxes which are received by the States and redistributed according to some ratio, not in proportion to the amounts collected in each locality; they are also called "State share, to be granted to local units." Bureau of the Census, State Tax Collections, 1941-1942, p. 9.

The text above does not make this distinction. Revenue directed to the localities out of specific State tax collections is considered local shares. See Hugh D. Ingersoll, "The Concept of the Shared Tax," Taxes, vol. 18, No. 10, October 1940, p. 596.

[44] Wisconsin retains for State use the entire proceeds of the emergency 60 percent surtax and of the privilege dividend tax.

[45] Wisconsin has increased the percentage of normal income tax collections retained by the State from 10 to 40 percent.

[46] In New York State, the county share has fallen from 50 percent of all collections to 50 percent of the revenue that would have been collected if the rates of the tax had remained unchanged as follows: On amounts of income not exceeding $10,000, 1 percent; $10,000 to $50,000, 2 percent; and 3 percent on amounts in excess of $50,000.

[47] This holds for all segments of income except the very lowest. Recent data for the State of Wisconsin indicate that persons with very low incomes, under $1,000, receive a slightly larger proportion of their income in the form of property receipts than those in the income class $1,000-$2,000. Wisconsin Individual Income Tax Statistics, 1936, vol. I, Madison, 1939, pp. A1-A13.

While all State individual-income-tax rate structures are graduated, none of them approaches the heights of the Federal scale.[48] The highest maximum State rate is 15 percent, attained at taxable incomes of $15,000 in North Dakota and $250,000 in California. Twenty-six of the States, including New York and Massachusetts, go no higher than 7 percent; of these, in turn, 8 do not even reach a maximum rate of 5 percent. While the maximum rates are generally low, in consideration of the high Federal rates,[49] graduation is fairly steep, although confined to a narrow range of income brackets. Only in California, New Mexico, and South Dakota does graduation proceed beyond the $25,000 income level. In fact, about half the States terminate graduation below $10,000.

Except for four States,[50] where changes in effective rates between 1929 and 1938 were relatively insignificant, and the States with classified income taxes,[51] the trend in individual income-tax rates during the depression period was substantially upward. The increases were larger for the higher incomes in Mississippi, Missouri, North Dakota, and Wisconsin. On the other hand, the rate increases were largely centered in the lower incomes in North and South Carolina. New York, Oklahoma, and Oregon distributed their rate increases throughout the income groups. The trend toward higher rates in the 'thirties is also evidenced by the States imposing income taxes after 1929. The newer taxes of California, Idaho, and Minnesota are among the highest.

Of the 32 States that tax corporate net income, only 7 apply graduated rates—namely, Arizona, Arkansas, Idaho, Mississippi, North Dakota, South Dakota, and Wisconsin. In Arkansas, Idaho, Mississippi, and South Dakota, the corporate rate structures are identical with the individual income-tax-rate structures. They differ slightly in Wisconsin and in Arizona, by only 0.5 percent at the maximum. The only considerable difference is in North Dakota, where the corporate rates range from 3 to 6 percent, but the individual rates range from 1 to 15 percent. The reasons for graduation of the State rates on corporate net income are apparently 2—the belief that the ability-to-pay principle applies to corporations, and the desire not to tax heavily the small, individually owned concern.[52] The second reason is consistent with the fact that in 2 States graduation ceases at $6,000 and that only in South Dakota does it extend beyond the $25,000 bracket.

The remaining 25 States, in conformity with expert opinion,[53] apply flat rates. Graduated or flat, the rates are uniformly low, 8 percent being the maximum. The model rate, 6 percent, is hardly representative, since 21 States fall under it. The median rate lies between 4 and 4½ percent.

[48] In 1933, Montana passed a surtax ranging from 1 to 25 percent (the latter on income in excess of $100,000) in addition to the maximum normal rate of 4 percent. At that time the Federal surtax rate was 55 percent. The Supreme Court of Montana declared the surtax arbitrary in operation and therefore unconstitutional (*Mills* v. *Board of Equalization* (May 12, 1934)). The basis of the invalidation was the grammatical proposition that semicolons, unlike commas, separate distinct sentences. In consequence, the surtax was interpreted to apply only to that portion of income which was in excess of the lower limit of the income bracket to which the relevant tax rate applied, with the accumulated tax liability on the income below this lower limit disregarded.

[49] This regard for the level of Federal rates is a form of unilateral (State) coordination.

[50] Arkansas, Delaware, Virginia, and Georgia.

[51] Massachusetts, New Hampshire, and Tennessee

[52] Janet R. Sundelson, "Taxation of Corporate Income at Progressive Rates: The State and Federal Experience Compared," Bulletin of the National Tax Association, vol. 26, No. 6, March 1941, p. 171.

[53] Twentieth Century Fund, Facing the Tax Problem, New York, 1937, p. 397.

Six States, all of whose net income taxes on corporations are in the form of excises on the corporate franchise, collect a low minimum flat fee of $5 to $25. These States are California, Connecticut, Montana, New York, Oregon, and Utah. Three other States—Georgia, Massachusetts, and South Carolina (and also Connecticut and New York) [54]—impose other minima, usually related to the value of capital stock.

(*h*) *Treatment of property income.*

While many States have provisions for the favorable treatment of dividends, government interest, and capital gains—all in the realm of unearned income—very few discriminate against them. Only Colorado and Oregon levy a surtax on income from intangibles, 2 percent in magnitude in each case. While Maryland, Massachusetts, and Vermont tax income from intangibles at a higher rate than earned income, they have not incorporated this distinction in a general progressively graduated income tax.

(*i*) *Apportionment and other jurisdictional procedure.*

The possibilities of diversity in the apportionment of corporate income are very great. In practice, the diversity is considerable though not as great as sometimes supposed.

Some attempt at apportionment is required in the case of a foreign corporation. In the case of a domestic corporation, a State may tax the entire income, wherever earned. The grant of apportionment to domestic corporations is not within the constitutional requirement of due process. It is rather a concern of correct economic policy. To withhold from domestic corporations a concession granted to foreign corporations, whatever the basis for the action, is to put the former at a competitive disadvantage. In 1938, a committee appointed by the National Tax Association [55] to study the allocation of business income among the States found that of 32 States that levy corporate income taxes, 26 allow domestic corporations to apportion their income, 5 do not (New Mexico not classified).[56] In 2 of the States [57] where the income of domestic corporations may not be apportioned, a credit may be applied against the tax of the home State for the amount of taxes paid to other States on account of portions of income taxed in other States.

In agreement with the report of the committee of the National Tax Association on the apportionment between the States of taxes on mercantile and manufacturing businesses in 1922, the 1939 committee on allocation of income recommended that income from interest, dividends, royalties, and the sale of intangible capital assets be specifically allocated to sources within and without the State taxing the income. Nonoperating income is to be assigned to a given State if received in connection with business carried on in that State. If a definite allocation to a particular State in which the corporation may be doing business is impossible, such income is to be allocated to the State where the chief office of the corporation is located. Net income from rents and from the sale of tangible capital assets is to be allocated to the State where the property is located.

[54] New York imposes a minimum with respect to salaries paid, to prevent tax avoidance.

[55] Leo Mattersdorf, chairman, "Report of the Committee of the National Tax Association on the Allocation of Income," Proceedings of the National Tax Association, 1938, p. 486, and 1939, p. 190.

[56] Alabama, Arkansas, Colorado, Louisiana, and North Carolina. New Mexico allocates overhead expenses, not gross receipts, and is treated throughout this section of the report as a special case.

[57] Alabama and Colorado.

Eight States now permit the specific allocation of all nonoperating income and all capital gains and losses. Thirteen other States allow only certain types of nonoperating income to be treated differently from operating business income. Eleven States refuse to distinguish between types of income and tax total net income as a unit. The last group does not sanction any form of income allocation by accounting.[58]

Under some circumstances, most States permit the computation of net income by means of separate accounts, which are presumably designed to show only the income from business done in the taxing State. Some States apply separate accounting to as many corporations as they possibly can.

Of the 26 replies from State tax commissions that the Committee on Allocation of Income of the National Tax Association received with respect to separate accounting,[59] 9 stated that they preferred corporations to use separate accounting.[60] The other 17 preferred the formula method of allocating business income among the States. Nine States stated that they provided that the mathematical formula be used only as an alternative where separate accounting failed to achieve equity. The other 17 used the formula primarily, with most of them, however, permitting separate accounting as an alternative.[61] Where separate accounting is preferred, the commission said that requirements as to corporate records are usually so rigid that it is improbable that many corporations could qualify for the use of that method. Where the formula is preferred, separate accounting is generally discouraged by the taxing authorities.[62]

Proponents of separate accounting merely advocate its use where the accounting system adequately reflects the income status of what are almost separate businesses. What they fail to recognize is the significance of overhead costs, and the difficulty of apportioning correctly such costs. In addition, they overlook the fact that in relations between a parent corporation and a subsidiary, it is almost impossible to determine what constitutes a fair billing price. To resolve this question adequately, an integrated concern must sell not only to its subsidiaries but to independent concerns as well. Certainly there can be no separate accounting where no independent factory price is available.[63]

Allocation of business income by means of the apportionment fraction, i. e., by mathematical formula, has, therefore, come into widespread use. These formulas are designed to arrive at the fraction of such income that is reasonably attributable to a given State. They do so by allocating income in accordance with the ratio of certain business factors within and without the State.

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[58] L. M. McBride, "Jurisdictional Aspects of State Income Taxation," Taxes, vol. 17, No. 4, April 1939, p. 243.

[59] Six States did not answer this question: Colorado, Maryland, Missouri, New Mexico, North Carolina, and Vermont.

[60] Arizona, Arkansas, Idaho, Iowa, Kentucky, Louisiana, Mississippi, Oklahoma, and Wisconsin.

[61] William B. Wood, An Analysis and Summary of Replies to the Questionnaire of the Allocation Committee of the National Tax Association, mimeographed, Bureau of Government, University of Michigan, April 1939. Apparently three of the States, Alabama, New York, and Pennsylvania, do not permit separate accounting under any circumstances. While this is probably the practice, this position is necessarily false in theory. It runs counter to the Supreme Court decision in *Hans Rees' Sons* v. *North Carolina* (283 U. S. 123 (1931)), which ruled that if the taxpayer can show conclusively that the formula allocation procedure operates unfairly, he is entitled to a separate accounting, whether or not the statute gives it to him.

[62] Mattersdorf, 1939, op. cit., p. 195. However, the opinion of the National Tax Association committee that very few corporations are likely to qualify for separate accounting is not supported by data. Professor Ford indicates that 46 percent of the corporations whose income is apportioned in Wisconsin were subject to separate accounting. R. S. Ford, Allocation of Corporation Income for Purposes of State Taxation, New York State Tax Commission, special report No. 6, 1933, p. 76.

[63] Ford, op. cit., p. 34.

The factors of the formulas vary widely between the several States and between classes of income in the same State. Tangible property and sales are the most popular. Ratios based on pay roll, manufacturing costs, and intangible property are strong second choices, and one State, North Dakota, employs "a business ratio," which is merely a conglomeration of purchases, pay roll, and sales. Where more than one factor is used, the percentage of net income assigned to the taxing State is equal to the weighted arithmetic average of the individual percentages of the several factors used. There is little uniformity in the weights attaching to various factors.

The 1939 committee of the National Tax Association found 16 formulas in use.[64]

Factors and number of States using these factors

1.	Property, pay roll, sales	10
2.	Property, manufacturing costs, sales	7
3.	Property, sales	8
4.	Sales	8
5.	Property, manufacturing costs	1
6.	Property, cost of sales, sales	1
7.	Property, pay roll	2
8.	Property, shares of other corporations, accounts receivable	1
9.	Property, pay rolls, sales, purchases	1
10.	Property	1
11.	Manufacturing costs	1
12.	Marketing costs	1
13.	Property, pay roll, sales, manufacturing costs	1
14.	Cost of sales	1
15.	Property, pay roll, purchases	1
16.	Loans, wages, interest	1

However, in the opinion of the committee, the 16 formulas exaggerate the impression of nonuniformity.

1. This number includes both general formulas and alternative formulas. The alternative formulas represent an attempt by the States to use the formula that is best adapted to a particular type of corporation, and not a different treatment of the same type of corporation.[65]

2. Formulas Nos. 1, 2, and 6, which are quite similar, are employed in 18 States. If the appropriate factor is added to formulas Nos. 3, 5, and 7, uniformity will have been achieved in 23 States. On the other hand, it may be argued that the 16 formulas understate the extent of nonuniformity. For instance, while the committee of the National Tax Association found 16 formulas in use, 1 corporation claimed to be subject to 30.[66] The corporation may be overstating its compliance difficulties. But there are differences in the statutory definitions of the factors entering the 16 formulas, in the weights attached to the factors, and in the method of arriving at net income, which may really result in a need for the determination of income in the several States by as many as 30 different methods.

It appears that most of these formulas have not been significantly revised since their adoption. However, some States have changed from a one-factor to a multiple-factor formula.[67]

Various committees of the National Tax Association, since 1922, have wrestled with the problem of apportionment factors, seeking the

[64] Mattersdorf, 1939, op. cit., p. 193.
[65] It is still possible, of course, for one corporation to take on different characteristics and therefore be subject to different formulas in the several States.
[66] Mattersdorf, 1939, op. cit., p. 200.
[67] Connecticut and Tennessee. Wood, op. cit., pp. 7-8.

ideal combination to recommend.[68] The 1939 committee, following in the main the views of its predecessor (committee appointed 1930; report, 1933), recommended the allocation of the income of mercantile or manufacturing businesses by means of the Massachusetts formula. Purchases were excluded from the recommended formula because they readily lend themselves to manipulation. A corporation can usually manage to locate the situs of purchases at the head office.

The Massachusetts formula, which accords equal weight to the three factors, tangible property, pay roll, and sales, has these advantages: it and its modifications are widely used; its factors are easily ascertainable, involving no allocation of overhead costs; it is on the average no less equitable than any other arithmetic formula; it has been satisfactorily tested in the light of Massachusetts experience; and its legality has been upheld.[69]

The formula suffers, of course, from disadvantages. The property factor generally fails to include the value of rented property employed in the business, which exerts economic effort toward the creation of income. Since the tax on the corporation is related to volume of the business, rented property should be included. An alternative would be to follow Connecticut practice and disallow the deduction, for purposes of determining net income, of rent or interest paid out by the corporation. However, if rent income is specifically allocated to the State of the property's situs, the property from which the rent income is derived should be excluded from apportionment.

There are also many who contend that the use of the pay-roll factor to supplement property and sales simply adds a greater weight to manufacturing than to selling and results in the manufacturing ratio being weighted at two-thirds in the allocation fraction.[70] Even if this allegation were true, the bias introduced by the pay-roll factor is less than would be caused by a cost-of-manufacturing factor. Perhaps the fault is not with the third factor; it may lie with the property factor, which is hardly indicative of business activity.[71] Still, the property factor is probably too widely entrenched to be cast aside when uniformity is sought.

The individual components of the Massachusetts formula require some elaboration. The treatment of the pay-roll factor is generally satisfactory.[72] Wages and salaries are apportioned to the office in which the employee works or the State where the office out of which he works, or with which he is connected, is located.

However, there is wide variation in the definition of the sales factor.[73] The committee on income allocation of the National Tax Association considered six methods of allocating sales to a State:[74] (1) The State to which payment for the sale is made, (2) the State from which the goods are shipped, (3) the State to which the goods sold are shipped, (4) the State from which the salesmen making the sales function, (5) the State where the order is accepted, (6) the State from which the billing is made.

The committee disapproved of methods (1) and (6), because neither the State to which payment is made nor the State of billing appears to

[68] Herbert Klarman, Personal and Business Net Income Taxation in the States, monograph prepared for this report.

[69] *Turco Paint & Varnish Co.* v. *Kaloder* (320 Pa. 421, 184 Atl. 37 (1936)).

[70] Ford, op. cit., p. 60.

[71] McBride, op. cit., p. 244.

[72] Mattersdorf, 1939, op. cit., p. 208.

[73] Ibid., p. 208. Ford, op. cit., p. 95. Wood, op. cit., p. 7, says: "Differences in the definition of the sales factor are probably a greater source of nonuniformity than the differences between the pay roll, manufacturing costs, and cost of sales factors."

[74] Mattersdorf, 1939, op. cit., p. 209.

make a significant contribution toward the earning of income.[75] Methods (2) and (5) were also opposed, for different reasons. The State from which the goods sold are shipped receives ample consideration in the property factor of the formula, and also in the general property tax. Furthermore, if the shipment is made from a warehouse owned by someone else in a State where the taxpayer is not engaged in doing business, the State cannot exercise jurisdiction to tax. To locate the situs of a sale at the place where the order is accepted is objectionable because of the absence of economic effort at that point and because of the possibility of manipulating this place. True, this method has been given great weight in legal decisions.[76] However, the committee felt that "no definite principle is enunciated [by the courts] or can be taken as a guide." [77]

The committee approved of methods (3) and (4) and recommended that they be used together: "It is recommended that each sale be divided into two equal parts and that 50 percent of the amount of each sale be apportioned to the State of destination of the merchandise shipped by the taxpayer, and 50 percent to the State from which the salesmen making the sales function." [78]

This method of allocation has not been applied by any State, probably for legal reasons. The committee agreed that the State of destination might be without the power to tax. However, the State of destination factor is only one-half of sales, and a much smaller percent of total income. The occasional escape of this small fraction was not thought to be serious, especially since in most cases it may be expected that the corporation will usually be doing business in the State of destination, and therefore be subject to tax.[79]

There is also a difference of opinion and practice as to whether one formula should be used for all corporations. A possible alternative is to apply different formulas to different types of corporations. This involves possibilities of diverse treatment in the classification of corporations. Also, varying degrees of discretion to depart from established formulas in exceptional cases may be allowed administrators.

A small minority of the States, three in number, have decided that over-all substantial justice suffices, and have devised apportionment formulas from which the tax authorities may not deviate.[80] At the other extreme are a small group of States, eight in number, who have left all discretion, including the devising of the formulas, with the tax

[75] The committee set up economic effort in the State as the criterion of the State's jurisdiction over an allocation factor. "When taxing net income or franchises whose values are measured by net income, the States are not taxing the gross receipts or sales but are directly or indirectly taxing the net income which is the result, not only of the sales, but of every other activity leading up to the sale in which the taxpayer may be engaged. The States, in the use of factors in a formula, whether they be tangible property, pay roll, sales, or any other, should be guided by the economic effort that produces the income. It is this economic effort evidenced by activity in various States that produces the net result, namely, net income." Ibid., p. 209.

[76] *Norfolk and Western Railway Company* v. *Sims* (191 U. S. 441 (1903)). *Compania General de Tobacos de Filipinos* v. *Collector* (279 U. S. 306 (1929)).

[77] Mattersdorf, 1939, op. cit., p. 213.

[78] Ibid., p. 214. T. R. Powell made a similar suggestion in 1925, "Business Taxes and the Federal Constitution," National Tax Association Proceedings, 1925, pp. 164 ff. In a sense this suggestion is similar to the practice of some States, such as New York, Vermont, and Virginia, which construe sales to mean the sale of goods within the State, wherever manufactured and the sale of goods manufactured within the State wherever sold (Ford, op. cit., p. 94). This double definition of sales is identical with the rule proposed by the committee of the National Tax Association if the sale of goods within the State, wherever manufactured, refers to the State of delivery and the sale of goods manufactured within the State, wherever sold, refers to the State from which the salesmen function.

[79] Ibid., p. 216.

[80] Arkansas, Connecticut, and New York cannot under their constitutions permit the tax administrator to formulate apportionment fractions. Arkansas goes further, not even permitting the equitable adjustment of the statutory formula. Wood, op. cit., p. 17.

commissions.[81] Between these two extremes lie the mass of State laws. In some, apportionment is made by taking the arithmetic average of several ratios, but permitting the tax commission, when petitioned by the taxpayer, to authorize the use of a more suitable ratio selected from a group of statutory ratios. In others, the same selectivity is available to a commission on its own motion if, in its opinion, strict mathematical apportionment does not properly reflect net income allocable to that State.[82] The majority of the laws, in fact, specify in one section what ratio or ratios are to be employed, and in the next section grant to the tax commission a blank check to be filled in with any method of apportionment that, in the opinion of the commission, will attain the proper result. Such provisions have generally been sustained.[83]

It will be recalled that apportionment of corporation income is but one of the jurisdictional problems created largely by the diversity of State procedures. Some States tax personal income where earned and others at the residence of its recipient. And residence itself is variously defined. Credits to residents or nonresidents are sometimes allowed, but these also vary from State to State.

3. YIELD AND IMPORTANCE OF STATE INCOME TAXES

Combined State individual and corporation income-tax collections reached $100 millions in 1920 for the first time; climbed to $200 millions by 1929; slumped badly between 1931 and 1933; began recovering in 1934; and attained $300 millions in 1937 and $433 millions in fiscal year 1941. An accurate break-down of State income-tax collections into its two components, individual and corporation, is not always available. The closest approach to complete segregation was made in 1938. The data for that year indicate that the ratio of corporation to individual income-tax collections for all the States is about 44 to 56.

New York State individual income-tax collections are consistently more than half of the total individual income-tax collections for all States (table 50). In 1937, the ratio was as high as 59 percent. In fact, the "Big Four," New York, California, Massachusetts, and Wisconsin, collected 72 percent of State individual income-tax revenues in 1941. Despite an increase in the number of income-tax States from 13 in 1922 to 35 in 1941, the position of the "Big Three," Wisconsin, Massachusetts, and New York, remained predominant. The "Big Three" still collected 53.7 percent of all State income-tax revenues (including corporation income taxes) in 1941 (table 51).

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[81] With respect to foreign corporations, eight States leave the determination of the apportionment formula to the administrator. The States are Alabama, California, Idaho, Louisiana, Mississippi, Montana, Oregon, and Vermont. Of these, six treat their domestic corporations similarly. Two others, Alabama and Louisiana, do not permit their domestic corporations to apportion income.

[82] The Committee on Uniformity and Reciprocity, 1933, suggested that where one or two of the allocating factors appear to be inapplicable, the remainder of the net income be allocated by the remaining two or one factors. However, a factor is not inapplicable merely because the numerator of a fraction is zero. Only if both the numerator and denominator are zero is the factor inapplicable (National Tax Association Proceedings, 1933, pp. 265–266). Pennsylvania employs this procedure.

[83] Faced with the dilemma of prescribing formulas so rigid in their application to any and all types of business that they are likely to be held unconstitutional for denying due process, or making the apportionment specifications so vague or pliable as to be endangered by attack on the grounds of an illegal delegation of power by the legislature, the States have usually chosen the latter risk. Two decisions have discounted the risk: *United Advertising Corp.* v. *Lynch* (63 F. (2d) 243 (C. C. A. 2d, 1933)); *Western Union Telegraph Co.* v. *Query* (144 S. C. 234, 142 S. E. 509 (1927)). A third turned the risk into reality and voided such a section in the New York law: *B. P. Ducas Co.* v. *State Tax Commission* (260 N. Y. 525, 184 N. E. 77 (1932)). Still other courts have reminded tax commissions that they cannot embark on an apportionment scheme of their own, at least in the absence of a statutory authorization to do so: *Fisher* v. *Standard Oil Co.* (12 F. (2d) 744 (C. C. A. 8th, 1926)); *Commonwealth* v. *P. Lorillard Co.* (129 Va. 74, 105 S. E. 683 (1921)); *Ford Motor Co.* v. *State* (65 N. D. 316, 258 N. W. 596 (1935)); *State Revenue Commission* v. *Edgar Bros. Co.* (55 Ga. App. 505, 190 S. E. 623 (1937)). See McBride, op. cit., p. 245, note 60. Perhaps the belief that flexibility would be to the advantage of the State treasury has been another factor making for vague legislation in this field.

TABLE 50.—*Collections from State individual income taxes, 1930–41*

[In thousands]

State	1930	1931	1932	1933	1934	1935	1936
Alabama					$215	$352	$499
Arizona					118	201	315
Arkansas	$595	$332	$156	$96	90	160	189
California							6,526
Colorado							
Delaware	2,853	1,924	577	654	692	768	918
Georgia	267	414	435	310	525	706	975
Idaho			35	30	115	258	405
Iowa						1,828	3,260
Kansas					456	814	1,070
Kentucky							
Louisiana						925	1,018
Maryland							
Massachusetts	31,786	22,554	17,692	12,824	14,132	16,570	18,449
Minnesota					977	1,199	2,173
Mississippi	638	366	196	196	208	393	489
Missouri	2,812	2,009	2,435	2,193	2,144	2,657	3,304
Montana					153	286	380
New Hampshire	596	632	643	592	412	348	410
New Mexico					18	37	72
New York	80,493	39,495	30,424	29,827	45,687	58,743	89,580
North Carolina	1,780	1,029	1,606	1,445	1,313	1,729	1,898
North Dakota	231	226	105	51	101	175	236
Oklahoma	524	356	766	847	661	965	1,537
Oregon		1,724	1,772	1,074	1,260	1,679	2,142
South Carolina	436	385	237	115	608	862	899
South Dakota							50
Tennessee	572	749	680	559	484	573	585
Utah			246	163	183	212	499
Vermont			625	446	371	399	454
Virginia	2,289	2,048	1,251	938	594	808	1,039
West Virginia							1,148
Wisconsin	9,225	8,939	7,769	11,619	7,273	6,304	5,283
Total	135,097	83,232	67,650	63,979	78,790	99,951	145,802

State	1937	1938	1939	1940	1941
Alabama	[2] $1,023	[1] $1,127	[1] $1,918	[3] $999	[3] $1,539
Arizona	[1] 407	[1] 450	586	[3] 436	[3] 470
Arkansas	342	344	342	[3] 362	[3] 480
California	[1] 16,776	21,450	20,672	19,572	20,287
Colorado		526	[1 3] 1,336	[3] 1,924	2,267
Delaware	[1] 1,285	1,455	1,097	1,662	1,556
Georgia	[2] 1,217	2,500	2,283	2,501	[4] 3,260
Idaho	[2] 438	699	[1] 699	[3] 549	[3] 673
Iowa	[1] 4,050	3,874	3,488	3,973	4,788
Kansas	1,461	1,663	1,362	1,349	1,560
Kentucky	[1] 1,802	2,468	1,960	2,351	2,810
Louisiana	[1] 1,483	2,404	2,615	2,401	2,798
Maryland		650	577	6,338	5,346
Massachusetts	[1] 24,517	[1] 23,791	20,292	[1] 20,292	21,184
Minnesota	2,541	3,079	[3] 5,353	[3] 5,776	7,992
Mississippi	707	1,159	855	887	[4] 1,317
Missouri	[5] 2,764	[1 5] 3,711	[1 5] 3,562	[5] 3,472	[5] 3,779
Montana	[1] 486	502	434	543	659
New Hampshire	[1] 483	687	690	587	636
New Mexico	94	132	[3] 195	[3] 156	[3] 203
New York	[1] 121,853	[1] 123,472	103,347	104,721	115,965
North Carolina	[1] 2,644	3,039	2,768	3,278	3,929
North Dakota	[2] 237	293	[3] 251	[3] 353	419
Oklahoma	[1] 2,960	3,450	2,486	2,424	2,439
Oregon	[1] 2,169	3,616	[1 3] 3,597	[3] 3,632	[3] 4,790
South Carolina	1,366	1,546	[3] 1,122	[3] 1,404	[3] 1,833
South Dakota	[4] 383	[4] 460	[4] 453	[1] 704	614
Tennessee	[4] 796	[1 4] 1,993	1,410	1,670	1,776
Utah	[1] 805	860	692	803	892
Vermont	[2] 533	580	[3] 546	[3] 616	[3] 698
Virginia	[1] 1,411	2,016	2,161	1,943	2,530
West Virginia	[1] 1,672	1,847	1,311	1,598	1,753
Wisconsin	[1] 8,500	[1] 8,811	8,410	8,532	9,551
Total	207,205	224,654	198,870	207,808	230,793

[1] Data from Tax Policy League, Tax Yields: 1940.
[2] 1937 ratio of individual to total net income-tax collections from Bureau of the Census, Financial Statistics of States, 1937, applied to total income-tax collections.
[3] 1938 ratio of individual to total net income-tax collections from Bureau of the Census, Financial Statistics of States, 1938, applied to total income-tax collections.
[4] 1940 ratio of individual to total net income-tax collections from Bureau of the Census, State Tax Collections, 1940; applied to total income-tax collections. For South Dakota, ratio is from Tax Yields: 1940.
[5] Half of total income-tax collections, since no break-down was available for any year.

Sources: 1930–36: Treasury Department, Division of Tax Research. 1937–41: Bureau of the Census, State Tax Collections (annually), as modified by footnotes above.

TABLE 51.—*Annual income tax collections of Big Three* [1] *and Big Five* [2] *income tax States, 1922–41 (amount and percentage of all State income-tax collections)*

Year	Number of States collecting income taxes	Collections of Big Three		Collections of Big Five	
		Amount	Percentage of all collections	Amount	Percentage of all collections
		Thousands		*Thousands*	
1922	13	$86,352	88.5	[3] $86,352	88.5
1923	14	81,126	87.5	81,126	87.5
1924	15	85,027	84.1	85,027	84.1
1925	15	98,413	85.9	98,413	85.9
1926	15	112,816	84.1	112,816	84.1
1927	15	138,434	85.3	138,434	85.3
1928	15	157,693	85.7	157,693	85.7
1929	15	175,784	86.2	175,784	86.2
1930	19	201,282	83.9	[4] 208,123	86.7
1931	19	156,903	81.6	163,505	85.0
1932	23	114,866	79.0	119,646	82.3
1933	23	96,640	80.0	99,999	82.7
1934	28	100,359	76.1	104,376	79.1
1935	30	112,123	71.5	117,010	74.6
1936	33	164,783	64.8	[5] 199,257	78.3
1937	34	227,869	62.0	292,240	79.5
1938	35	232,786	57.9	304,182	75.6
1939	35	195,367	56.6	252,802	73.3
1940	35	199,624	53.8	263,570	71.1
1941	35	[6] 232,424	53.7	[6] 305,472	70.6

[1] Wisconsin, Massachusetts, and New York. Massachusetts data are not comparable throughout: For 1912–28, data include only personal income-tax collections; for 1937–41, they include yield of tax on corporate excess; for other years, they include only net income tax portion of corporate tax yield.
[2] Wisconsin, Massachusetts, New York, California, and Pennsylvania.
[3] 1922–29, California and Pennsylvania levied no income taxes.
[4] California began to collect income taxes.
[5] Pennsylvania began to collect corporation income taxes. 1936 is also the year in which the yield of the California taxes became sizable.
[6] Tentative.

Sources: 1922–28: National Industrial Conference Board, State Income Taxes, vol. II, New York, 1930, p. 154. 1929: Bureau of the Census, Financial Statistics of States, 1929, p. 64. 1930–36: Treasury Department, Division of Research and Statistics, Collections from Selected State-Imposed Taxes, 1930–36, table 7. 1937–41: Bureau of the Census, Annual State Tax Collections, and Tax Policy League, Tax Yields: 1940.

The role of the income tax in the tax systems of the States on the whole is not a very important one. Thirteen States, some of them among the wealthiest, have no income tax at all. Because of the frequent unavailability of a break-down between the individual and corporation income-tax collections for certain States, it is necessary to employ the combined collection figures for comparisons among States. The proportion of total State tax collections from these taxes varies, not only with the extent to which they have been developed, but also with the extent to which States have developed other tax sources in order to assist local governments. The proportion of total State and local revenues from income taxes would be a better measure of dependence on these sources.

Inspection of the data in table 52 shows that 4 income-tax States derive less than 5 percent of collections from the income tax. The presence of West Virginia in this group is understandable, for this State does not levy a corporation tax. More surprising and most significant is the presence of North Dakota. This State has the lowest personal exemptions and the highest maximum tax rates of any of the States. The paucity of the tax base is the dominant factor.

rates, which now attain a maximum of 83⅓ percent, were formerly relatively low, reaching a maximum of 50 percent in 1940. While the graduation was and still is steep, now ceasing at a low level of income, $10,000,[21] it rises under each pound of income,[22] thus applying a lower effective rate to the tax deduction than under a bracket system. The State tax rates are higher, on the whole, in Australia than in this country. Victoria ranks lowest, with a maximum rate of only 9.06 percent on earned income; but this rate applies to every dollar of taxable income, if income exceeds $40,000 (£10,000).[23] The New South Wales rates reach a peak of 23 percent,[24] and while the exact Queensland rates are not available, their maximum is known to be considerably in excess of 25 percent.[25] The combination of a Federal tax rate of 50 percent with a State rate of 30 percent would, under unilateral deductibility, yield a combined effective rate of 65 percent. Since the corresponding combined effective rate in Victoria would be 54.5 percent, the tax differential between residents of Victoria and Queensland would be 10.5 percent. If the Queensland rate is 40 percent, the tax differential [26] becomes 15.5 percent. Under the new Commonwealth rates of 83.3 percent, the maximum differentials under unilateral deductibility are 3.5 and 5.2 percent, when the Queensland maximum tax rates are 30 and 40 percent, respectively. It appears that sizable differentials in the effective rates of tax existed in Australia among residents of the several States before the high rates of 1941 were enacted, and might conceivably have furnished the basis for the movement to eliminate the State income taxes.

The States were asked to discontinue their income taxes for the period of the war, and legislation to that end has passed Parliament and has been approved by the Court. Suspension of State income taxes has been accompanied by (1) transfer to the Commonwealth of State administrative machinery and staffs; (2) an increase in Commonwealth rates corresponding to an "average" State schedule; and (3) provision of grants to the States.

(c) *Canada.*

The Dominion of Canada imposed direct taxes for the first time when it adopted the income tax in 1917. At that time only three of the nine Provinces had income taxes (British Columbia and Prince Edward Island, provincial, and Nova Scotia, municipal).[27] In recent

[21] The sum of $10,000 refers to £2,500, where graduation ceases on the "personal exertion" rate scale. On the "property" rate scale, the limit of graduation is now £2,000.

[22] The Australian rate structure is a positively sloped straight line, with constant differences in rates between each pound of income. The straight line or arithmetic progression represents a gain in equity and is conceptually simple, but requires complex mathematical manipulation by the taxpayer.

[23] Barkmeier, op. cit., p. 12.

[24] Ibid.

[25] Carslaw, op. cit., p. 26.

[26] In the present context, the tax differential signifies the difference in tax liability between a resident of a given State and a resident of Victoria, the State with the lowest income tax. For an analysis of how deductibility affects tax differentials see the discussion on p. 437ff.

[27] The actual distribution of power between the Dominion and the Provinces resembles that between the Federal Government of the United States and the several States, although on the face they are quite different. By the British North American Act, analogous to the Constitution of the United States, the Federal Government was given the power to legislate on about 29 specific subjects and also a general residual power "to make laws for the peace, order, and good government of Canada," about all matters "not assigned exclusively to the legislatures of the Provinces." While the Canadian Constitution grants the residual power to the Dominion, judicial interpretation has so whittled it away, that it appears now that the Provincial power to legislate about "property and civil rights" is the real residual power (J. A. Maxwell, Discussion of Intergovernmental Fiscal Relationships, Proceedings of the National Tax Association, 1940, pp. 218 219). The result of this reshuffling of powers has been that most of the new expensive functions of the Government have been allocated to the Provinces, resulting in the severe need for funds by the Provinces and their adoption of the income tax (R. M. Fowler, "Inter-Governmental Fiscal Relations in Canada," Proceedings of the National Tax Association, 1940, p. 208). The Dominion has more or less respected the predicament of the Provinces and has been reluctant, at first to invade, and then to exploit, the field of direct taxation, since this was the source of most Provincial revenues (Stuart S. Garson, "The Effects of the War Upon the Canadian Provincial Fiscal Systems," Proceedings of the National Tax Association, 1941, pp. 59-60).

years all the Provinces have entered the field,[28] thus giving gradual rise to Dominion-Provincial conflicts in this area. Apparently the situation became quite serious, especially in the field of corporate taxation, for in 1940 the Royal Commission on Dominion-Provincial Relations [29] recommended, among other measures, the retirement of the Provinces from the fields of personal income tax, corporation tax, and the inheritance tax, in return for compensation. The opposition of some of the Provinces prevented immediate action but the war forced the Dominion to disregard Provincial objections and to set the rates of its personal and corporation income taxes at the maximum level possible. And the Provinces have agreed, as a temporary measure, to abandon their own income taxes in return for grants that fully compensate them for lost revenues.

Before the retirement of the Provinces from the income-tax field for the duration, four of them [30] had entrusted the administration of the income tax to the Dominion.

In the case of these Provinces the same officers, organization, income-tax forms, notices, and returns of the taxpayer were utilized both for the Dominion and the Provincial taxes. Thus in Ontario, for example, the taxpayer filed only one return and dealt with only one "inspector's office." He received one "notice of assessment" specifying separately the Dominion and the Provincial income taxes. He made payment to one office and received one receipt.[31] In general, the Provincial systems were closely analogous to the Dominion income tax.[32] This facilitated the use of a single return for both taxes.

Income taxes paid to the Provinces did not constitute a deductible expense under the Dominion law. While three Provinces, Ontario, Prince Edward Island, and Manitoba, allowed the Dominion income tax to be deducted from the Provincial tax base as a concession to the taxpayer, they did not thereby succeed in substantially reducing interstate taxpayer differentials. The main reason is that the rate structures of the Provinces not permitting deductions were, on the whole, just as high as those of the Provinces permitting deductions.[33] In fact, under the 1941 Dominion maximum rates of 85 percent, the combination of Federal and Provincial taxes would have confiscated the income above certain brackets in three of the Provinces not permitting deductions and almost confiscated it in the fourth.[34]

2. DIVERSITIES IN STATE LAWS

(a) Dividends.

Diversity of State income taxes in the United States is quite substantial. One of the major points of difference is in the treatment of dividends. There is less diversity in the treatment of stock dividends

[28] New Brunswick and Nova Scotia income taxes on individuals are municipal.

[29] Report of the Royal Commission on Dominion-Provincial Relations, Ottawa, 1940.

[30] Ontario (1936), Manitoba (1937), Prince Edward Island (1937), and Quebec (1939). Figures in parentheses indicate dates of initiation of Dominion administration.

[31] Commerce Clearing House, Canadian Tax Service, vol. 1, New York, 1941, p. 902 (par. 10-007).

[32] Ibid., p. 902 (par. 10-607). "In fact the acts of Alberta, Manitoba, Ontario, Prince Edward Island, Quebec, and Saskatchewan are modeled on the Dominion Act. Even the act of British Columbia, which has a history of its own, antedating that of the Dominion by many years, is very similar. Consequently, a determination of taxable income for Dominion purposes is usually accepted for Provincial purposes."

[33] The maximum rates in the Provinces permitting deductions are: Ontario, 28 percent; Prince Edward Island, 10 percent; Manitoba, 50 percent.

[34] The maximum rates in the Provinces not permitting deductions were: Alberta, 31 percent; British Columbia, 28 percent; Quebec, 12 percent; Saskatchewan, 37 percent. The combined maximum Dominion and provincial rates were: Alberta, 116 percent; British Columbia, 113 percent; Quebec, 97 percent; Saskatchewan, 122 percent. The addition of the National Defense Tax of 5 percent renders all four combinations confiscatory. It will be noted, furthermore, that the municipal income taxes levied in Montreal and in municipalities of the three Maritime Provinces have not been taken into consideration.

than of cash dividends. For the former, an overwhelming majority of the States follow Federal leadership and do not include stock dividends in income. Only five States subject stock dividends to taxation—North Dakota, Oklahoma, Oregon, South Carolina, and Vermont.

The treatment of cash dividends is more varied, ranging from exemption—which may take the form of an exclusion, a deduction, or a credit—to additional taxation. With minor qualifications, eight States exclude dividends from individual gross income to the extent that they are paid out of the income of corporations already taxed by them. Three States, Iowa, Missouri, and South Dakota, aim at a similar but more equitable result by allowing a credit equal to the amount of the corporation tax on dividends paid out of taxed corporate income. Since the first two apply a flat rate to corporate income, they state the credit in terms of that rate. Four States, Alabama, Arizona, Idaho, and Wisconsin, employ the so-called "50–50 rule," whereby such dividends as are derived from corporations earning more than 50 percent of their income in the taxing State are entirely deducted from the income of the individual taxpayer. Seventeen States, including three that do not impose a corporation tax, tax dividends fully, like other income. With the exception of Vermont, all States levying both personal income taxes and corporation franchise taxes measured by net income, as distinct from direct income taxes on corporations, fall into this group. Finally, two States, Colorado and Oregon, impose surtaxes on dividends, in addition to including them in full, like other income, under the regular income tax.

The varying treatment of dividends in the State income-tax statutes may be associated with corresponding conceptions of the relation between corporation and individual income taxes.

(*b*) *Interest from local, State, and Federal securities.*

All personal income-tax States now exempt the interest from obligations of the United States; on the other hand, all tax the income from obligations of other States and their political subdivisions. With respect to the income from obligations of the home State, the treatment varies: 9 tax it, 24 exempt it. In addition, 3 more States, or 12 in all, tax the interest from the obligations of the political subdivisions of the home State.

The treatment of the interest from Federal obligations under the State corporation-income taxes also shows considerable diversity. Nine of the eleven States that levy corporate franchise taxes measured by net income [35] tax Federal interest. All the remaining 21 States which impose direct income taxes exempt such interest. Fifteen of the States tax the interest on their own obligations. This number includes all but one [36] of the 9 States which both levy corporate franchise taxes and tax Federal interest and all the States which tax the interest from their own obligations under the individual income taxes.[37] Sixteen States, the above 15 and Virginia, also tax the interest from the obligations of their political subdivisions. All but

[35] California, Connecticut, Massachusetts, Minnesota, Montana, New York, Oregon, Tennessee, Utah, Pennsylvania, and Vermont do not tax the income from Federal bonds. Federal interest is taxed in California and Minnesota under the franchise tax; it is exempt under the direct income tax.

[36] Tennessee.

[37] Colorado, Idaho, Iowa, Kansas, Oklahoma, South Dakota, and Wisconsin.

2[38] of the States appear to tax the income from the obligations of other States and their subdivisions. These exceptions may be attributed to the total adoption of the Federal definition of income. Notwithstanding favorable judicial attitudes[39] toward the inclusion of interest in the base of State corporation-income taxes, 23 of the income-tax States exempt the income from the securities of the Federal Government and its agencies. With respect to the 21 States which have corporate net income taxes other than franchise taxes, the treatment of interest from Federal obligations is generally the same for corporations and individuals.

(c) *Concept of income.*

The income tax, as administered, is based essentially on an exchange concept of income. While no income-tax statute in the United States grants an explicit exemption to farmers on the consumption of home-produced commodities, ineffective administration of the statutes in this area practically achieves the same purpose. Wisconsin is the exception, including for farmers a presumptive income for food consumed of $90 for each adult, and $60 for each minor living on the farm. Wisconsin also attempted, originally, to tax the rental value of an owner-occupied home as a part of income, but later abandoned this feature.

(d) *Personal exemptions.*

All the individual-income-tax States except Tennessee grant personal exemptions. In turn, all except New Hampshire, which taxes only income from intangibles, allow a greater sum to married persons or heads of families than to single individuals.

The personal exemption is generally given as a deduction from income. However, five States, Arizona, Iowa, Minnesota, South Dakota, and Wisconsin, express the exemptions in the form of tax credits, and two more, Kentucky and Louisiana, achieve the equivalent result by having the income allowance deducted from the lowest income bracket.

Until 1940 an overwhelming majority of the States had exemptions lower than, or equal to the Federal standard of $1,000 for a single individual and $2,500 for a married person or head of family. Now only six States have exemptions that are equal to or less than the Federal level (at $750 and $1,500).

The exemption for single persons is $1,000 in 19 States. Exemptions of less than this amount, ranging from $200 in New Hampshire to $850 in Oklahoma, prevail in 9 States. In addition, 3 States grant exemptions of $1,500 and 1 State, an exemption of $2,000. One State, Tennessee, grants none.

(e) *Community property.*

The community-property provision in some State laws affects tax liability for both State and Federal purposes. This provision declares that husband and wife have a joint interest in the earnings of either, of from the property resulting from the earnings of either, after their marriage.

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[38] Pennsylvania and Tennessee. The data on the latter are not clear.
[39] *Pacific Co., Ltd.*, v. *Johnson* (285 U. S. 480 (1932)).

Until recently there were eight community-property States.[40] Lately Oklahoma has enacted a similar provision, the validity of which the Bureau of Internal Revenue has thus far refused to recognize.[41] Of the other eight States, five levy State individual income taxes[42] in which cases the community-property provision, in effect, lightens both the State and the Federal income-tax burden below the effective rate generally indicated.

(*f*) *Disposition of proceeds.*

In 24 States all the collections from income taxes go to State funds, in 10 they are shared with the local units, and in 2 the entire sum is distributed to local units. Even where the collections remain with the State, the entire sum, or a portion thereof, may be earmarked for the performance of special functions, e. g., education or welfare, which elsewhere are within the province of the localities.

Over 18 percent of the total State income-tax collections of $423 millions in 1941 were distributed to the localities.[43] Massachusetts, Minnesota, New York, and Wisconsin distributed over 90 percent of this sum. Where income-tax collections are shared between the State and the localities, there has been a tendency for the portion going to the latter to decline. The localities are refused participation in new surtaxes,[44] and their share in the old taxes may be reduced by lowering the percentage of total collections distributed to them,[45] or by restricting their share to a constant percentage of that portion of the collections attributable to the old tax rates, with all the collections resulting from an increase in rates accruing to the State.[46]

(*g*) *Nominal rate structures.*

The rate structures of the State individual income taxes are all progressive. Twenty-eight States explicitly provide for progressive rates. Three States, Massachusetts, Maryland, and Vermont, vary the rate with respect to income sources, attaching a higher tax rate to investment income; two others, Tennessee and New Hampshire, tax only income from intangibles. Insofar as investment income constitutes a higher percentage of large than of small incomes[47] the exclusive taxation of such income or the imposition of a higher tax rate upon it is a rough approximation to progressive graduation. Everywhere the tax rates are applied to portions or brackets of the individual's income.

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[40] Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

[41] Probably because the Oklahoma scheme was avowedly adopted as a tax-competing and therefore tax-evasion device.

[42] Arizona, California, Idaho, Louisiana, and New Mexico.

[43] The Bureau of the Census distinguishes between "shared taxes" and "grants from specified sources." The former relate to taxes distributed substantially in proportion to the amount collected in each locality. The latter are grants from taxes which are received by the States and redistributed according to some ratio, not in proportion to the amounts collected in each locality; they are also called "State share, to be granted to local units." Bureau of the Census, State Tax Collections, 1941-1942, p. 9.

The text above does not make this distinction. Revenue directed to the localities out of specific State tax collections is considered local shares. See Hugh D. Ingersoll, "The Concept of the Shared Tax," Taxes, vol. 18, No. 10, October 1940, p. 596.

[44] Wisconsin retains for State use the entire proceeds of the emergency 60 percent surtax and of the privilege dividend tax.

[45] Wisconsin has increased the percentage of normal income tax collections retained by the State from 10 to 40 percent.

[46] In New York State, the county share has fallen from 50 percent of all collections to 50 percent of the revenue that would have been collected if the rates of the tax had remained unchanged as follows: On amounts of income not exceeding $10,000, 1 percent; $10,000 to $50,000, 2 percent; and 3 percent on amounts in excess of $50,000.

[47] This holds for all segments of income except the very lowest. Recent data for the State of Wisconsin indicate that persons with very low incomes, under $1,000, receive a slightly larger proportion of their income in the form of property receipts than those in the income class $1,000-$2,000. Wisconsin Individual Income Tax Statistics, 1936, vol. I, Madison, 1939, pp. A1-A13.

While all State individual-income-tax rate structures are graduated, none of them approaches the heights of the Federal scale.[48] The highest maximum State rate is 15 percent, attained at taxable incomes of $15,000 in North Dakota and $250,000 in California. Twenty-six of the States, including New York and Massachusetts, go no higher than 7 percent; of these, in turn, 8 do not even reach a maximum rate of 5 percent. While the maximum rates are generally low, in consideration of the high Federal rates,[49] graduation is fairly steep, although confined to a narrow range of income brackets. Only in California, New Mexico, and South Dakota does graduation proceed beyond the $25,000 income level. In fact, about half the States terminate graduation below $10,000.

Except for four States,[50] where changes in effective rates between 1929 and 1938 were relatively insignificant, and the States with classified income taxes,[51] the trend in individual income-tax rates during the depression period was substantially upward. The increases were larger for the higher incomes in Mississippi, Missouri, North Dakota, and Wisconsin. On the other hand, the rate increases were largely centered in the lower incomes in North and South Carolina. New York, Oklahoma, and Oregon distributed their rate increases throughout the income groups. The trend toward higher rates in the 'thirties is also evidenced by the States imposing income taxes after 1929. The newer taxes of California, Idaho, and Minnesota are among the highest.

Of the 32 States that tax corporate net income, only 7 apply graduated rates—namely, Arizona, Arkansas, Idaho, Mississippi, North Dakota, South Dakota, and Wisconsin. In Arkansas, Idaho, Mississippi, and South Dakota, the corporate rate structures are identical with the individual income-tax-rate structures. They differ slightly in Wisconsin and in Arizona, by only 0.5 percent at the maximum. The only considerable difference is in North Dakota, where the corporate rates range from 3 to 6 percent, but the individual rates range from 1 to 15 percent. The reasons for graduation of the State rates on corporate net income are apparently 2—the belief that the ability-to-pay principle applies to corporations, and the desire not to tax heavily the small, individually owned concern.[52] The second reason is consistent with the fact that in 2 States graduation ceases at $6,000 and that only in South Dakota does it extend beyond the $25,000 bracket.

The remaining 25 States, in conformity with expert opinion,[53] apply flat rates. Graduated or flat, the rates are uniformly low, 8 percent being the maximum. The model rate, 6 percent, is hardly representative, since 21 States fall under it. The median rate lies between 4 and 4½ percent.

[48] In 1933, Montana passed a surtax ranging from 1 to 25 percent (the latter on income in excess of $100,000) in addition to the maximum normal rate of 4 percent. At that time the Federal surtax rate was 55 percent. The Supreme Court of Montana declared the surtax arbitrary in operation and therefore unconstitutional (*Mills* v. *Board of Equalization* (May 12, 1934)). The basis of the invalidation was the grammatical proposition that semicolons, unlike commas, separate distinct sentences. In consequence, the surtax was interpreted to apply only to that portion of income which was in excess of the lower limit of the income bracket to which the relevant tax rate applied, with the accumulated tax liability on the income below this lower limit disregarded.

[49] This regard for the level of Federal rates is a form of unilateral (State) coordination.

[50] Arkansas, Delaware, Virginia, and Georgia.

[51] Massachusetts, New Hampshire, and Tennessee

[52] Janet R. Sundelson, "Taxation of Corporate Income at Progressive Rates: The State and Federal Experience Compared," Bulletin of the National Tax Association, vol. 26, No. 6, March 1941, p. 171.

[53] Twentieth Century Fund, Facing the Tax Problem, New York, 1937, p. 397.

Six States, all of whose net income taxes on corporations are in the form of excises on the corporate franchise, collect a low minimum flat fee of $5 to $25. These States are California, Connecticut, Montana, New York, Oregon, and Utah. Three other States—Georgia, Massachusetts, and South Carolina (and also Connecticut and New York) [54]—impose other minima, usually related to the value of capital stock.

(*h*) *Treatment of property income.*

While many States have provisions for the favorable treatment of dividends, government interest, and capital gains—all in the realm of unearned income—very few discriminate against them. Only Colorado and Oregon levy a surtax on income from intangibles, 2 percent in magnitude in each case. While Maryland, Massachusetts, and Vermont tax income from intangibles at a higher rate than earned income, they have not incorporated this distinction in a general progressively graduated income tax.

(*i*) *Apportionment and other jurisdictional procedure.*

The possibilities of diversity in the apportionment of corporate income are very great. In practice, the diversity is considerable though not as great as sometimes supposed.

Some attempt at apportionment is required in the case of a foreign corporation. In the case of a domestic corporation, a State may tax the entire income, wherever earned. The grant of apportionment to domestic corporations is not within the constitutional requirement of due process. It is rather a concern of correct economic policy. To withhold from domestic corporations a concession granted to foreign corporations, whatever the basis for the action, is to put the former at a competitive disadvantage. In 1938, a committee appointed by the National Tax Association [55] to study the allocation of business income among the States found that of 32 States that levy corporate income taxes, 26 allow domestic corporations to apportion their income, 5 do not (New Mexico not classified).[56] In 2 of the States [57] where the income of domestic corporations may not be apportioned, a credit may be applied against the tax of the home State for the amount of taxes paid to other States on account of portions of income taxed in other States.

In agreement with the report of the committee of the National Tax Association on the apportionment between the States of taxes on mercantile and manufacturing businesses in 1922, the 1939 committee on allocation of income recommended that income from interest, dividends, royalties, and the sale of intangible capital assets be specifically allocated to sources within and without the State taxing the income. Nonoperating income is to be assigned to a given State if received in connection with business carried on in that State. If a definite allocation to a particular State in which the corporation may be doing business is impossible, such income is to be allocated to the State where the chief office of the corporation is located. Net income from rents and from the sale of tangible capital assets is to be allocated to the State where the property is located.

[54] New York imposes a minimum with respect to salaries paid, to prevent tax avoidance.

[55] Leo Mattersdorf, chairman, "Report of the Committee of the National Tax Association on the Allocation of Income," Proceedings of the National Tax Association, 1938, p. 486, and 1939, p. 190.

[56] Alabama, Arkansas, Colorado, Louisiana, and North Carolina. New Mexico allocates overhead expenses, not gross receipts, and is treated throughout this section of the report as a special case.

[57] Alabama and Colorado.

Eight States now permit the specific allocation of all nonoperating income and all capital gains and losses. Thirteen other States allow only certain types of nonoperating income to be treated differently from operating business income. Eleven States refuse to distinguish between types of income and tax total net income as a unit. The last group does not sanction any form of income allocation by accounting.[58]

Under some circumstances, most States permit the computation of net income by means of separate accounts, which are presumably designed to show only the income from business done in the taxing State. Some States apply separate accounting to as many corporations as they possibly can.

Of the 26 replies from State tax commissions that the Committee on Allocation of Income of the National Tax Association received with respect to separate accounting,[59] 9 stated that they preferred corporations to use separate accounting.[60] The other 17 preferred the formula method of allocating business income among the States. Nine States stated that they provided that the mathematical formula be used only as an alternative where separate accounting failed to achieve equity. The other 17 used the formula primarily, with most of them, however, permitting separate accounting as an alternative.[61] Where separate accounting is preferred, the commission said that requirements as to corporate records are usually so rigid that it is improbable that many corporations could qualify for the use of that method. Where the formula is preferred, separate accounting is generally discouraged by the taxing authorities.[62]

Proponents of separate accounting merely advocate its use where the accounting system adequately reflects the income status of what are almost separate businesses. What they fail to recognize is the significance of overhead costs, and the difficulty of apportioning correctly such costs. In addition, they overlook the fact that in relations between a parent corporation and a subsidiary, it is almost impossible to determine what constitutes a fair billing price. To resolve this question adequately, an integrated concern must sell not only to its subsidiaries but to independent concerns as well. Certainly there can be no separate accounting where no independent factory price is available.[63]

Allocation of business income by means of the apportionment fraction, i. e., by mathematical formula, has, therefore, come into widespread use. These formulas are designed to arrive at the fraction of such income that is reasonably attributable to a given State. They do so by allocating income in accordance with the ratio of certain business factors within and without the State.

58 L. M. McBride, "Jurisdictional Aspects of State Income Taxation," Taxes, vol. 17, No. 4, April 1939, p. 243.

59 Six States did not answer this question: Colorado, Maryland, Missouri, New Mexico, North Carolina, and Vermont.

60 Arizona, Arkansas, Idaho, Iowa, Kentucky, Louisiana, Mississippi, Oklahoma, and Wisconsin.

61 William B. Wood, An Analysis and Summary of Replies to the Questionnaire of the Allocation Committee of the National Tax Association, mimeographed, Bureau of Government, University of Michigan, April 1939. Apparently three of the States, Alabama, New York, and Pennsylvania, do not permit separate accounting under any circumstances. While this is probably the practice, this position is necessarily false in theory. It runs counter to the Supreme Court decision in *Hans Rees' Sons* v. *North Carolina* (283 U. S. 123 (1931)), which ruled that if the taxpayer can show conclusively that the formula allocation procedure operates unfairly, he is entitled to a separate accounting, whether or not the statute gives it to him.

62 Mattersdorf, 1939, op. cit., p. 195. However, the opinion of the National Tax Association committee that very few corporations are likely to qualify for separate accounting is not supported by data. Professor Ford indicates that 46 percent of the corporations whose income is apportioned in Wisconsin were subject to separate accounting. R. S. Ford, Allocation of Corporation Income for Purposes of State Taxation, New York State Tax Commission, special report No. 6, 1933, p. 76.

63 Ford, op. cit., p. 34.

The factors of the formulas vary widely between the several States and between classes of income in the same State. Tangible property and sales are the most popular. Ratios based on pay roll, manufacturing costs, and intangible property are strong second choices, and one State, North Dakota, employs "a business ratio," which is merely a conglomeration of purchases, pay roll, and sales. Where more than one factor is used, the percentage of net income assigned to the taxing State is equal to the weighted arithmetic average of the individual percentages of the several factors used. There is little uniformity in the weights attaching to various factors.

The 1939 committee of the National Tax Association found 16 formulas in use.[64]

Factors and number of States using these factors

1.	Property, pay roll, sales	10
2.	Property, manufacturing costs, sales	7
3.	Property, sales	8
4.	Sales	8
5.	Property, manufacturing costs	1
6.	Property, cost of sales, sales	1
7.	Property, pay roll	2
8.	Property, shares of other corporations, accounts receivable	1
9.	Property, pay rolls, sales, purchases	1
10.	Property	1
11.	Manufacturing costs	1
12.	Marketing costs	1
13.	Property, pay roll, sales, manufacturing costs	1
14.	Cost of sales	1
15.	Property, pay roll, purchases	1
16.	Loans, wages, interest	1

However, in the opinion of the committee, the 16 formulas exaggerate the impression of nonuniformity.

1. This number includes both general formulas and alternative formulas. The alternative formulas represent an attempt by the States to use the formula that is best adapted to a particular type of corporation, and not a different treatment of the same type of corporation.[65]

2. Formulas Nos. 1, 2, and 6, which are quite similar, are employed in 18 States. If the appropriate factor is added to formulas Nos. 3, 5, and 7, uniformity will have been achieved in 23 States. On the other hand, it may be argued that the 16 formulas understate the extent of nonuniformity. For instance, while the committee of the National Tax Association found 16 formulas in use, 1 corporation claimed to be subject to 30.[66] The corporation may be overstating its compliance difficulties. But there are differences in the statutory definitions of the factors entering the 16 formulas, in the weights attached to the factors, and in the method of arriving at net income, which may really result in a need for the determination of income in the several States by as many as 30 different methods.

It appears that most of these formulas have not been significantly revised since their adoption. However, some States have changed from a one-factor to a multiple-factor formula.[67]

Various committees of the National Tax Association, since 1922, have wrestled with the problem of apportionment factors, seeking the

[64] Mattersdorf, 1939, op. cit., p. 193.
[65] It is still possible, of course, for one corporation to take on different characteristics and therefore be subject to different formulas in the several States.
[66] Mattersdorf, 1939, op. cit., p. 200.
[67] Connecticut and Tennessee. Wood, op. cit., pp. 7-8.

ideal combination to recommend.[68] The 1939 committee, following in the main the views of its predecessor (committee appointed 1930; report, 1933), recommended the allocation of the income of mercantile or manufacturing businesses by means of the Massachusetts formula. Purchases were excluded from the recommended formula because they readily lend themselves to manipulation. A corporation can usually manage to locate the situs of purchases at the head office.

The Massachusetts formula, which accords equal weight to the three factors, tangible property, pay roll, and sales, has these advantages: it and its modifications are widely used; its factors are easily ascertainable, involving no allocation of overhead costs; it is on the average no less equitable than any other arithmetic formula; it has been satisfactorily tested in the light of Massachusetts experience; and its legality has been upheld.[69]

The formula suffers, of course, from disadvantages. The property factor generally fails to include the value of rented property employed in the business, which exerts economic effort toward the creation of income. Since the tax on the corporation is related to volume of the business, rented property should be included. An alternative would be to follow Connecticut practice and disallow the deduction, for purposes of determining net income, of rent or interest paid out by the corporation. However, if rent income is specifically allocated to the State of the property's situs, the property from which the rent income is derived should be excluded from apportionment.

There are also many who contend that the use of the pay-roll factor to supplement property and sales simply adds a greater weight to manufacturing than to selling and results in the manufacturing ratio being weighted at two-thirds in the allocation fraction.[70] Even if this allegation were true, the bias introduced by the pay-roll factor is less than would be caused by a cost-of-manufacturing factor. Perhaps the fault is not with the third factor; it may lie with the property factor, which is hardly indicative of business activity.[71] Still, the property factor is probably too widely entrenched to be cast aside when uniformity is sought.

The individual components of the Massachusetts formula require some elaboration. The treatment of the pay-roll factor is generally satisfactory.[72] Wages and salaries are apportioned to the office in which the employee works or the State where the office out of which he works, or with which he is connected, is located.

However, there is wide variation in the definition of the sales factor.[73] The committee on income allocation of the National Tax Association considered six methods of allocating sales to a State: [74] (1) The State to which payment for the sale is made, (2) the State from which the goods are shipped, (3) the State to which the goods sold are shipped, (4) the State from which the salesmen making the sales function, (5) the State where the order is accepted, (6) the State from which the billing is made.

The committee disapproved of methods (1) and (6), because neither the State to which payment is made nor the State of billing appears to

[68] Herbert Klarman, Personal and Business Net Income Taxation in the States, monograph prepared for this report.
[69] *Turco Paint & Varnish Co. v. Kaloder* (320 Pa. 421, 184 Atl. 37 (1936)).
[70] Ford, op. cit., p. 60.
[71] McBride, op. cit., p. 244.
[72] Mattersdorf, 1939, op. cit., p. 208.
[73] Ibid., p. 203. Ford, op. cit., p. 95. Wood, op. cit., p. 7, says: "Differences in the definition of the sales factor are probably a greater source of nonuniformity than the differences between the pay roll, manufacturing costs, and cost of sales factors."
[74] Mattersdorf, 1939, op. cit., p. 209.

make a significant contribution toward the earning of income.[75] Methods (2) and (5) were also opposed, for different reasons. The State from which the goods sold are shipped receives ample consideration in the property factor of the formula, and also in the general property tax. Furthermore, if the shipment is made from a warehouse owned by someone else in a State where the taxpayer is not engaged in doing business, the State cannot exercise jurisdiction to tax. To locate the situs of a sale at the place where the order is accepted is objectionable because of the absence of economic effort at that point and because of the possibility of manipulating this place. True, this method has been given great weight in legal decisions.[76] However, the committee felt that "no definite principle is enunciated [by the courts] or can be taken as a guide." [77]

The committee approved of methods (3) and (4) and recommended that they be used together: "It is recommended that each sale be divided into two equal parts and that 50 percent of the amount of each sale be apportioned to the State of destination of the merchandise shipped by the taxpayer, and 50 percent to the State from which the salesmen making the sales function." [78]

This method of allocation has not been applied by any State, probably for legal reasons. The committee agreed that the State of destination might be without the power to tax. However, the State of destination factor is only one-half of sales, and a much smaller percent of total income. The occasional escape of this small fraction was not thought to be serious, especially since in most cases it may be expected that the corporation will usually be doing business in the State of destination, and therefore be subject to tax.[79]

There is also a difference of opinion and practice as to whether one formula should be used for all corporations. A possible alternative is to apply different formulas to different types of corporations. This involves possibilities of diverse treatment in the classification of corporations. Also, varying degrees of discretion to depart from established formulas in exceptional cases may be allowed administrators.

A small minority of the States, three in number, have decided that over-all substantial justice suffices, and have devised apportionment formulas from which the tax authorities may not deviate.[80] At the other extreme are a small group of States, eight in number, who have left all discretion, including the devising of the formulas, with the tax

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[75] The committee set up economic effort in the State as the criterion of the State's jurisdiction over an allocation factor. "When taxing net income or franchises whose values are measured by net income, the States are not taxing the gross receipts or sales but are directly or indirectly taxing the net income which is the result, not only of the sales, but of every other activity leading up to the sale in which the taxpayer may be engaged. The States, in the use of factors in a formula, whether they be tangible property, pay roll, sales, or any other, should be guided by the economic effort that produces the income. It is this economic effort evidenced by activity in various States that produces the net result, namely, net income." Ibid., p. 209.

[76] *Norfolk and Western Railway Company* v. *Sims* (191 U. S. 441 (1903)). *Compania General de Tobacos de Filipinos* v. *Collector* (279 U. S. 306 (1929)).

[77] Mattersdorf, 1939, op. cit., p. 213.

[78] Ibid., p. 214. T. R. Powell made a similar suggestion in 1925, "Business Taxes and the Federal Constitution," National Tax Association Proceedings, 1925, pp. 164 ff. In a sense this suggestion is similar to the practice of some States, such as New York, Vermont, and Virginia, which construe sales to mean the sale of goods within the State, wherever manufactured and the sale of goods manufactured within the State wherever sold (Ford, op. cit., p. 94). This double definition of sales is identical with the rule proposed by the committee of the National Tax Association if the sale of goods within the State, wherever manufactured, refers to the State of delivery and the sale of goods manufactured within the State, wherever sold, refers to the State from which the salesmen function.

[79] Ibid., p. 216.

[80] Arkansas, Connecticut, and New York cannot under their constitutions permit the tax administrator to formulate apportionment fractions. Arkansas goes further, not even permitting the equitable adjustment of the statutory formula. Wood, op. cit., p. 17.

commissions.[81] Between these two extremes lie the mass of State laws. In some, apportionment is made by taking the arithmetic average of several ratios, but permitting the tax commission, when petitioned by the taxpayer, to authorize the use of a more suitable ratio selected from a group of statutory ratios. In others, the same selectivity is available to a commission on its own motion if, in its opinion, strict mathematical apportionment does not properly reflect net income allocable to that State.[82] The majority of the laws, in fact, specify in one section what ratio or ratios are to be employed, and in the next section grant to the tax commission a blank check to be filled in with any method of apportionment that, in the opinion of the commission, will attain the proper result. Such provisions have generally been sustained.[83]

It will be recalled that apportionment of corporation income is but one of the jurisdictional problems created largely by the diversity of State procedures. Some States tax personal income where earned and others at the residence of its recipient. And residence itself is variously defined. Credits to residents or nonresidents are sometimes allowed, but these also vary from State to State.

3. YIELD AND IMPORTANCE OF STATE INCOME TAXES

Combined State individual and corporation income-tax collections reached $100 millions in 1920 for the first time; climbed to $200 millions by 1929; slumped badly between 1931 and 1933; began recovering in 1934; and attained $300 millions in 1937 and $433 millions in fiscal year 1941. An accurate break-down of State income-tax collections into its two components, individual and corporation, is not always available. The closest approach to complete segregation was made in 1938. The data for that year indicate that the ratio of corporation to individual income-tax collections for all the States is about 44 to 56.

New York State individual income-tax collections are consistently more than half of the total individual income-tax collections for all States (table 50). In 1937, the ratio was as high as 59 percent. In fact, the "Big Four," New York, California, Massachusetts, and Wisconsin, collected 72 percent of State individual income-tax revenues in 1941. Despite an increase in the number of income-tax States from 13 in 1922 to 35 in 1941, the position of the "Big Three," Wisconsin, Massachusetts, and New York, remained predominant. The "Big Three" still collected 53.7 percent of all State income-tax revenues (including corporation income taxes) in 1941 (table 51).

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[81] With respect to foreign corporations, eight States leave the determination of the apportionment formula to the administrator. The States are Alabama, California, Idaho, Louisiana, Mississippi, Montana, Oregon, and Vermont. Of these, six treat their domestic corporations similarly. Two others, Alabama and Louisiana, do not permit their domestic corporations to apportion income.

[82] The Committee on Uniformity and Reciprocity, 1933, suggested that where one or two of the allocating factors appear to be inapplicable, the remainder of the net income be allocated by the remaining two or one factors. However, a factor is not inapplicable merely because the numerator of a fraction is zero. Only if both the numerator and denominator are zero is the factor inapplicable (National Tax Association Proceedings, 1933, pp. 265–266). Pennsylvania employs this procedure.

[83] Faced with the dilemma of prescribing formulas so rigid in their application to any and all types of business that they are likely to be held unconstitutional for denying due process, or making the apportionment specifications so vague or pliable as to be endangered by attack on the grounds of an illegal delegation of power by the legislature, the States have usually chosen the latter risk. Two decisions have discounted the risk: *United Advertising Corp.* v. *Lynch* (63 F. (2d) 243 (C. C. A. 2d, 1933)); *Western Union Telegraph Co.* v. *Query* (144 S. C. 234, 142 S. E. 509 (1927)). A third turned the risk into reality and voided such a section in the New York law: *B. P. Ducas Co.* v. *State Tax Commission* (260 N. Y. 525, 184 N. E. 77 (1932)). Still other courts have reminded tax commissions that they cannot embark on an apportionment scheme of their own, at least in the absence of a statutory authorization to do so: *Fisher* v. *Standard Oil Co.* (12 F. (2d) 744 (C. C. A. 8th, 1926)); *Commonwealth* v. *P. Lorillard Co.* (129 Va. 74, 105 S. E. 683 (1921)); *Ford Motor Co.* v. *State* (65 N. D. 316, 258 N. W. 596 (1935)); *State Revenue Commission* v. *Edgar Bros. Co.* (55 Ga. App. 505, 190 S. E. 623 (1937)). See McBride, op. cit., p. 245, note 60. Perhaps the belief that flexibility would be to the advantage of the State treasury has been another factor making for vague legislation in this field.

TABLE 50.—*Collections from State individual income taxes, 1930–41*

[In thousands]

State	1930	1931	1932	1933	1934	1935	1936
Alabama					$215	$352	$499
Arizona					118	201	315
Arkansas	$595	$332	$156	$96	90	160	189
California							6,526
Colorado							
Delaware	2,853	1,924	577	654	692	768	918
Georgia	267	414	435	310	525	706	975
Idaho			35	30	115	258	405
Iowa						1,828	3,260
Kansas					456	814	1,070
Kentucky							
Louisiana						925	1,018
Maryland							
Massachusetts	31,786	22,554	17,692	12,824	14,132	16,570	18,449
Minnesota					977	1,199	2,173
Mississippi	638	366	196	196	208	393	489
Missouri	2,812	2,009	2,435	2,193	2,144	2,657	3,304
Montana					153	286	380
New Hampshire	596	632	643	592	412	348	410
New Mexico					18	37	72
New York	80,493	39,495	30,424	29,827	45,687	58,743	89,580
North Carolina	1,780	1,029	1,606	1,445	1,313	1,729	1,898
North Dakota	231	226	105	51	101	175	236
Oklahoma	524	356	766	847	661	965	1,537
Oregon		1,724	1,772	1,074	1,260	1,679	2,142
South Carolina	436	385	237	115	608	862	899
South Dakota							50
Tennessee	572	749	680	559	484	573	585
Utah			246	163	183	212	499
Vermont			625	446	371	399	454
Virginia	2,289	2,048	1,251	938	594	808	1,039
West Virginia							1,148
Wisconsin	9,225	8,989	7,769	11,619	7,273	6,304	5,283
Total	135,097	83,232	67,650	63,979	78,790	99,951	145,802

State	1937	1938	1939	1940	1941
Alabama	[2] $1,023	[1] $1,127	[1] $1,918	[4] $999	[4] $1,539
Arizona	[1] 407	[1] 450	586	[3] 436	[4] 470
Arkansas	342	344	342	[3] 362	[3] 480
California	[1] 16,776	21,450	20,672	19,572	20,287
Colorado		526	[1 5] 1,336	[5] 1,924	2,267
Delaware	[1] 1,285	1,455	1,097	1,662	1,556
Georgia	[3] 1,217	2,500	2,283	2,501	[4] 3,260
Idaho	[2] 438	699	[1] 699	[3] 549	[3] 673
Iowa	[1] 4,050	3,874	3,488	3,973	4,788
Kansas	1,461	1,663	1,362	1,349	1,560
Kentucky	[1] 1,802	2,468	1,960	2,351	2,810
Louisiana	[1] 1,483	2,404	2,615	2,401	2,798
Maryland		650	577	6,338	5,346
Massachusetts	[1] 24,517	[1] 23,791	20,292	[1] 20,292	21,184
Minnesota	2,541	3,079	[5] 5,353	[5] 5,776	7,992
Mississippi	707	1,159	855	887	[4] 1,317
Missouri	[5] 2,764	[1 5] 3,711	[1 5] 3,562	[5] 3,472	[5] 3,779
Montana	[1] 486	502	434	543	659
New Hampshire	[1] 483	687	690	587	636
New Mexico	94	132	[5] 195	[5] 156	[5] 203
New York	[1] 121,853	[1] 123,472	103,347	104,721	115,965
North Carolina	[1] 2,644	3,039	2,768	3,278	3,929
North Dakota	[2] 237	293	[5] 251	[5] 353	419
Oklahoma	[1] 2,960	3,450	2,486	2,424	2,439
Oregon	[1] 2,169	3,616	[1 3] 3,597	[3] 3,632	[3] 4,790
South Carolina	1,366	1,546	[5] 1,122	[5] 1,404	[3] 1,833
South Dakota	[4] 383	[4] 460	[4] 453	[1] 704	614
Tennessee	[4] 798	[1 4] 1,993	1,410	1,670	1,776
Utah	[1] 805	860	692	803	892
Vermont	[3] 533	580	[3] 546	[3] 616	[4] 698
Virginia	[1] 1,411	2,016	2,161	1,943	2,530
West Virginia	[1] 1,672	1,847	1,311	1,598	1,753
Wisconsin	[1] 8,500	[1] 8,811	8,410	8,532	9,551
Total	207,205	224,654	198,870	207,808	230,793

[1] Data from Tax Policy League, Tax Yields: 1940.

[2] 1937 ratio of individual to total net income-tax collections from Bureau of the Census, Financial Statistics of States, 1937, applied to total income-tax collections.

[3] 1938 ratio of individual to total net income-tax collections from Bureau of the Census, Financial Statistics of States, 1938, applied to total income-tax collections.

[4] 1940 ratio of individual to total net income-tax collections from Bureau of the Census, State Tax Collections, 1940; applied to total income-tax collections. For South Dakota, ratio is from Tax Yields: 1940.

[5] Half of total income-tax collections, since no break-down was available for any year.

Sources: 1930–36: Treasury Department, Division of Tax Research. 1937–41: Bureau of the Census, State Tax Collections (annually), as modified by footnotes above.

TABLE 51.—*Annual income tax collections of Big Three* [1] *and Big Five* [2] *income tax States, 1922–41 (amount and percentage of all State income-tax collections)*

Year	Number of States collecting income taxes	Collections of Big Three: Amount	Collections of Big Three: Percentage of all collections	Collections of Big Five: Amount	Collections of Big Five: Percentage of all collections
		Thousands		*Thousands*	
1922	13	$86,352	88.5	[3] $86,352	88.5
1923	14	81,126	87.5	81,126	87.5
1924	15	85,027	84.1	85,027	84.1
1925	15	98,413	85.9	98,413	85.9
1926	15	112,816	84.1	112,816	84.1
1927	15	138,434	85.3	138,434	85.3
1928	15	157,693	85.7	157,693	85.7
1929	15	175,784	86.2	175,784	86.2
1930	19	201,282	83.9	[4] 208,123	86.7
1931	19	156,903	81.6	163,505	85.0
1932	23	114,866	79.0	119,646	82.3
1933	23	96,640	80.0	99,999	82.7
1934	28	100,359	76.1	104,376	79.1
1935	30	112,123	71.5	117,010	74.6
1936	33	164,783	64.8	[5] 199,257	78.3
1937	34	227,869	62.0	292,240	79.5
1938	35	232,786	57.9	304,182	75.6
1939	35	195,367	56.6	252,802	73.3
1940	35	199,624	53.8	263,570	71.1
1941	35	[6] 232,424	53.7	[6] 305,472	70.6

[1] Wisconsin, Massachusetts, and New York. Massachusetts data are not comparable throughout: For 1912–28, data include only personal income-tax collections; for 1937–41, they include yield of tax on corporate excess; for other years, they include only net income tax portion of corporate tax yield.
[2] Wisconsin, Massachusetts, New York, California, and Pennsylvania.
[3] 1922–29, California and Pennsylvania levied no income taxes.
[4] California began to collect income taxes.
[5] Pennsylvania began to collect corporation income taxes. 1936 is also the year in which the yield of the California taxes became sizable.
[6] Tentative.

Sources: 1922–28: National Industrial Conference Board, State Income Taxes, vol. II, New York, 1930, p. 154. 1929: Bureau of the Census, Financial Statistics of States, 1929, p. 64. 1930–36: Treasury Department, Division of Research and Statistics, Collections from Selected State-Imposed Taxes, 1930–36, table 7. 1937–41: Bureau of the Census, Annual State Tax Collections, and Tax Policy League, Tax Yields: 1940.

The role of the income tax in the tax systems of the States on the whole is not a very important one. Thirteen States, some of them among the wealthiest, have no income tax at all. Because of the frequent unavailability of a break-down between the individual and corporation income-tax collections for certain States, it is necessary to employ the combined collection figures for comparisons among States. The proportion of total State tax collections from these taxes varies, not only with the extent to which they have been developed, but also with the extent to which States have developed other tax sources in order to assist local governments. The proportion of total State and local revenues from income taxes would be a better measure of dependence on these sources.

Inspection of the data in table 52 shows that 4 income-tax States derive less than 5 percent of collections from the income tax. The presence of West Virginia in this group is understandable, for this State does not levy a corporation tax. More surprising and most significant is the presence of North Dakota. This State has the lowest personal exemptions and the highest maximum tax rates of any of the States. The paucity of the tax base is the dominant factor.

TABLE 52.—*Percentage of State tax collections from net income taxes, 1940*

State	Net income taxes as percent of total tax collections	State	Net income taxes as percent of total tax collections
Alabama	6.0	Montana	9.3
Arizona	7.7	New Hampshire	5.6
Arkansas	2.4	New Mexico	2.8
California	15.2	New York	33.0
Colorado	9.0	North Carolina	16.0
Connecticut	8.4	North Dakota	3.9
Delaware	15.9	Oklahoma	11.4
Georgia	12.7	Oregon	18.9
Idaho	13.1	Pennsylvania	9.6
Iowa	7.5	South Carolina	11.3
Kansas	5.6	South Dakota	5.5
Kentucky	10.3	Tennessee	8.1
Louisiana	7.3	Utah	9.9
Maryland	17.7	Vermont	8.0
Massachusetts	28.4	Virginia	9.9
Minnesota	14.5	West Virginia	3.5
Mississippi	6.0	Wisconsin	21.2
Missouri	9.0		

Source: Tax Institute, Tax Policy, vol. IX, No. 2, December 1941, p. 2.

Seven more States, New Hampshire, South Dakota, Iowa, Kansas, Louisiana, Mississippi, and Alabama, show combined income taxes as percentages of total State tax collections ranging from 5.1 to 7.5 percent. While the three latter States and South Dakota are poor, Iowa is considered to be the wealthiest agricultural State and Kansas is not far behind it. Apparently, in view of similarly small collection totals for the Federal income taxes in these States, the decisive factor is the general unproductiveness of farm income for income tax purposes, regardless of the level of the personal exemptions.

Ten States derive 7.6 to 10 percent of their State tax collections from income taxes. The two corporation-income-tax States, Pennsylvania and Connecticut, are included in this group, as are also a group of Rocky Mountain States.

Kentucky, Oklahoma, and South Carolina are in the 10.1–12.5 percent range, and the widely scattered trio of Idaho, Minnesota, and Georgia are in the 12.6–15 percent range. California, Oregon, Delaware, Maryland, and North Carolina show ratios between 15.1 and 20 percent.

Only three States derive more than 20 percent of their State tax collections from the income taxes. They are Wisconsin at 21.2 percent, Massachusetts at 28.4 percent, and New York at 33 percent. The two latter have high per capita incomes. Wisconsin, about half agricultural and half industrial, and only a median State in per capita income, demonstrates the potency of low exemptions, fairly high rates, and good administration.

4. PROBLEMS OF SUITABILITY IN STATE INCOME TAXATION

(a) *Factors of suitability.*

Income-tax revenues tend to vary substantially from year to year, although less than death-tax revenues. Income taxes tend to be very cycle sensitive and fluctuate with business prosperity. Also, unlike the inheritance tax, the fluctuations from year to year may be no greater for a State than for the Federal Government, though the latter has the advantage in that gains and losses in different parts of the country tend to offset each other. Applied to as small a unit as most cities and counties, the graduated personal income tax produces quite unstable revenues, and this factor combined with those of territorial competition and administrative difficulties renders the tax not well adapted to local use. However, a tax with very low exemptions, or none, and a flat rate, like the Philadelphia tax, may be reasonably satisfactory from the standpoint of steadiness of yield.

Perhaps the greatest complication in State taxation of income is that of determining what belongs to the tax base geographically. The problem is as great for the taxpayer as for the States. As previously explained, a variety of rules and procedures applied by the States to establish jurisdictional boundaries in income taxation results in substantial multiple taxation. Just how much is, unfortunately, largely a matter of conjecture. There seems little likelihood that the Supreme Court can be relied upon to clear up this injustice and impediment to cosmopolitan business. Uniformity movements and reciprocity legislation make only a small dent on the problem. Here is a matter that a coordination program should aim to alleviate. Within the jurisdictional problem, and to a certain extent beyond it, lies the contention that income, realized at one point but derived from a broad market and in a national economic system, should be taxed for the benefit of all the people or at least for the benefit of a wider population than that of one State.

An important factor in State income-tax development is the migration of wealth and industry, and propaganda concerning the alleged effects of the tax on economic development. This has been discussed in an earlier section of this report. Probably no factor has had so much weight in retarding the development of the State income tax as this.

In many States (including some of the wealthiest and most populous) there are impressive legal and constitutional barriers to income taxation. For example, Illinois passed an income tax in 1932, but it was declared unconstitutional by the State supreme court. The court took the view that income is property and thus subject to a uniformity clause in the State constitution. The Illinois Constitution is notoriously difficult to amend. The same situation prevails in several of the other non-income-tax States.[84]

With prevailing types of legislation and techniques of administration, it is impossible to make the income tax a very effective revenue producer in an agricultural State. The income tax is primarily an urban tax, and depends substantially upon an unequal distribution of wealth for its productivity. This is not to say that it is impossible to get large revenues in a poor rural State with relatively even distribution of income. But certainly the techniques for so doing, or perhaps the courage to try, have still to be developed. Thus, while the net-income tax in North Dakota has been the subject of acrimonious debates, the yield of the tax in that State has been a mere trifle compared with that of the property tax or the motor-vehicle taxes.

[84] Fear of judicial invalidation has hampered the income-tax movement considerably. Washington has made several attempts at income taxation, but the State courts have repeatedly upset the enactments of the legislature. In Indiana, fear of nullification prevented even initial enactment.

Some of the States which now levy income taxes also had to overcome judicial resistance. Alabama, Minnesota, and Oregon are in that group. While Pennsylvania now levies a corporation franchise tax, measured by net income, its personal income tax was voided by the State supreme court. (See Richard A. Girard, The Scope for Uniformity in State Tax Systems, Albany, 1935, pp. 111 ff.)

State income-tax administration is spotty in character. Some of it is at least as good as, and perhaps superior to, the Federal. But in many States, low personnel standards and starvation appropriations make the product far below what it should be.

Robert M. Haig has listed four "State-line" obstacles to efficient State tax administration:[85]

(1) *Interstate commerce.*—It is difficult for the States to impose a tax on interstate commerce. Many of them have therefore come to favor the delegation of more tax functions to the Federal Government. It appears that this difficulty relates principally to goods in transit; it is of minor importance for the income tax.

(2) *Localization of tax base.*—It is difficult to localize the tax base. Economically, it is difficult to determine the particular areas in which the profits of a far-flung business enterprise arise. Legally, there are obstacles to be overcome in the commerce clause and the due process clause of the Federal Constitution.

(3) *Interstate tax competition.*—Given a mobile tax base, the States may indulge in competitive bidding for it. It is not clear whether such bidding actually induces migration. However, if the States think that it does, they will not exploit their fiscal potentialities to the utmost.

(4) *Uneconomic administrative district.*—Some States have low taxable capacity. Modern streamlined State tax administration would not pay.

Probably the first of these difficulties is not very serious for the income tax. That the States need assistance from the Federal Government as to the other three must be conceded.

(*b*) *Should the States continue in the income tax field?*

There are many who believe that the income tax is an excellent source of revenue for the Federal Government, but that the States should stay out of this field. It is conceded by all that central units of government have many advantages over their subdivisions in the administration of the tax. On the other hand, it is argued that the income tax is too important and meritorious a means of revenue to be ignored on so large a front of expenditure as the States and municipalities represent. The latter provide most of the prime essentials of government, including such personal services as education, which very properly might be supported by a personal tax on net income. Most important, perhaps, is the fact that the income tax provides the one important available progressive tax by means of which the people of any State can eliminate or reduce the regressivity of their State and local tax systems. Unless independent State and local government is to disappear, some freedom in the choice of ways and means at the State and local level is exceedingly important. Some States are more inclined to apply the ability-to-pay theory than others and the State income tax gives them an opportunity to express this difference.

The State net income tax encounters heavy impediments of conflicting jurisdiction, multiple taxation, high compliance costs, uneconomical administration, and interstate competition. There are antidotes for all these limitations and none is so serious as to warrant a death sentence for the State income tax. It is true, of course, that the

[85] Robert Murray Haig, "The Coordination of the Federal and State Tax Systems," Proceedings of the National Tax Association, 1932, pp. 225-228.

State income tax does less to correct geographical maldistribution than the Federal. The Federal tax coupled with a well-ordered system of Federal aid would be most effective as a corrective of geographical maldistribution. This device is now being applied to some extent but quite imperfectly; it can be further developed and improved to relieve the pressure for new revenue for State and local tax systems. But this does not mean that the States need to be ruled out of the income-tax field.

5. DEDUCTIBILITY

(a) *Effects of deductibility.*

It should be observed at the outset of the discussion of this topic that a very large measure of coordination in the income-tax field has already been achieved through the deductibility features of Federal and many State laws. The effect of these features and their special significance during the war period will now be explained.

In view of the extensive and intensive development of the Federal income tax and its probable further development, the question of excessive burdens on the taxpayer is especially directed to the possibility of a confiscatory or near-confiscatory incidence of a combination of Federal and State income tax rates. The present maximum Federal rate of 80 percent and the maximum State rate of 15 percent (North Dakota and California) appear to approach confiscation. But appearances are deceiving. The deductibility of the State tax in calculating the base of the Federal tax, together with the deductibility of the Federal tax in calculating the base of the State tax in more than two-thirds of the income-tax States, make the effective rates considerably less than the nominal rates. State practice as to deductibility is summarized in table 53.

TABLE 53.—*Deductibility of Federal income taxes for purposes of State income taxes* [1] *(as of Jan. 1, 1942)*

State	Individual income tax	Corporation income tax
Alabama	Yes	Yes
Arizona [2]	do	do
Arkansas	do	do
California	No	No
Colorado	Yes	Yes
Connecticut	None imposed.	No
Delaware	Yes	None imposed.
District of Columbia	No	No
Georgia	Yes	Yes
Idaho	do	do
Iowa	do	do
Kansas	do	do
Kentucky	do	do
Louisiana	do	do
Maryland	No	No
Massachusetts: [3]		
Interest	do	do
Dividends	do	
Capital gains	do	
Partnerships	Yes	
Business income	do	
Wages and salaries	do	
Minnesota	Yes	Yes
Mississippi	No	No
Missouri	Yes	Yes
Montana	do	do
New Hampshire	No	None imposed.
New Mexico	Yes	Yes
New York	No	No
North Carolina	do	do
North Dakota	Yes	Yes
Oklahoma [2]	do	do
Oregon	do	No
Pennsylvania	None imposed.	Yes
South Carolina	No	No
South Dakota	Yes	Yes
Tennessee	No	do
Utah	Yes	do
Vermont	do	No
Virginia	No	do
West Virginia	Yes	None imposed.
Wisconsin [2 3]	do	Yes

[1] In general, each State which permits the deduction of Federal income taxes limits such deduction to taxes paid on that part of income subject to its own income tax.
[2] Also allows deductions for State income tax paid during previous tax year.
[3] Applicable to income of 1941 and subsequent years, the deduction is limited to 10 percent of net income (as computed without benefit of the deduction) in the case of corporate and 3 percent in the case of individual income taxpayers.

Source: Based on a survey of State income-tax statutes.

Neither New York nor California permits a taxpayer to deduct his Federal income-tax payments from gross income in computing State net taxable income. Wisconsin now limits the deduction to 10 percent of net income for corporations, and to 3 percent for noncorporate taxpayers. Massachusetts grants the deduction with respect to individual business income and wages, but it withholds it with respect to individual income from intangibles and all corporate income. Altogether, 22 of the 33 States imposing individual net-income taxes grant an unlimited Federal tax deduction. Two others limit it, and the remaining 9 deny it completely. Of the 32 States imposing corporation net-income taxes, 20 States grant an unlimited deduction, one (Wisconsin) limits it, and 11 deny it. While the partisans of deductibility are not precisely the same in both the individual and corporation net-income-tax fields, only 3 States pursue different policies with respect to tax deductibility in the 2 fields. For Tennessee, taxing individuals only on their income from intangibles, the diversity of treatment is reasonable. Oregon and Vermont allow the deduction to an individual, but not to a corporation.

The combination of Federal and State tax rates under various assumptions produces the results shown in table 54. From the table it can be seen that the combination of Federal and State taxes results in an effective rate only slightly higher under the third assumption than under the fourth, and not conspicuously higher under the second assumption than under the fourth.[86]

TABLE 54.—*Effective rates of combinations of selected maximum Federal rates with State income tax rate of 15 percent on portion of income subject to maximum rates, under various assumptions regarding tax deductibility*

Assumption	Effective rates (with maximum State rate of 15 percent)								
	Federal rate, 90 percent			Federal rate, 80 percent			Federal rate, 70 percent		
	Total	Federal	State	Total	Federal	State	Total	Federal	State
1. Neither tax is deductible in the calculation of the other	105.0	90.0	15.0	95.0	80.0	15.0	85.0	70.0	15.0
2. State tax is deductible in the calculation of the Federal tax	91.5	76.5	15.0	83.0	68.0	15.0	74.5	59.5	15.0
3. Federal tax is also deductible in the calculation of the State tax	90.1	88.4	1.7	80.7	77.3	3.4	71.5	66.5	5.0
4. State has no income tax	90.0	90.0	....	80.0	80.0	....	70.0	70.0	....

86 The computations are derived from the substitution of prevailing Federal and State tax rates in a pair of simultaneous equations:

$F=S_I+[I-(P_F+S+I_I)]r_I+[I-(P_F+E_F+S)]r_N$

$S=S_{II}+[I-(P_S+E_S+F+I_{II})]r_{II}$

When I=Total income less allowable deductions other than Federal and State income taxes paid
P_F= Federal personal exemption
P_S= State personal exemption
E_F= Federal earned income credit
I_I= Federal surtax net income below top bracket
I_{II}= State tax base below top bracket
S_I= Federal surtax on I_I
S_{II}= State tax on I_{II}
r_I= Federal surtax rate on top bracket
r_N= Federal normal rate
r_{II}= State rate on top bracket
F= Federal tax
S= State tax

(Formulae taken from memoranda of Division of Tax Research, U. S. Treasury Department.)

Thus, the deductibility feature is an insurance against a confiscatory combination. A Federal rate of 90 percent and a State rate of 15 percent, under the second assumption above, would result in a combined maximum effective rate of 91.5 percent; under the third assumption, 90.1 percent. Table 55 and chart 12 show the results of deductibility in specific States.

TABLE 55.—*Federal and State income tax liability as a percent of net income, under various assumptions and at 1941 rates, in California, Minnesota, New York, and Pennsylvania* [1]

Net income	California	Minnesota	New York	Pennsylvania
(a) Under assumption of no deductibility:	*Percent*	*Percent*	*Percent*	*Percent*
$3,000	4.8	4.9	4.9	4.6
$5,000	8.0	8.7	8.8	7.5
$20,000	25.1	28.8	28.0	23.1
$100,000	60.4	61.8	59.3	52.7
$1,000,000	87.3	83.2	80.2	73.3
$5,000,000	93.3	88.5	85.5	78.4
(b) Under assumption of unilateral (Federal) deductibility:				
$3,000	4.8	4.9	4.9	4.6
$5,000	7.9	8.5	8.6	7.5
$20,000	24.2	26.5	26.0	23.1
$100,000	55.2	55.6	54.8	52.7
$1,000,000	76.3	75.4	74.8	73.3
$5,000,000	81.3	80.4	79.8	78.4
(c) Under assumption of reciprocal deductibility:				
$3,000	4.7	4.9	4.8	4.6
$5,000	7.8	8.4	8.4	7.5
$20,000	23.7	25.2	25.0	23.1
$100,000	53.2	54.0	53.7	52.7
$1,000,000	74.0	73.9	73.7	73.3
$5,000,000	79.1	78.9	78.8	78.4

[1] The taxpayer is a married man without dependents; the community property law in California is disregarded; the tax credit in Minnesota is converted into a $2,000 deduction from income.

Although reciprocal deductibility results in the avoidance of confiscation in the application of the income tax to the high brackets, and also means the reduction to relatively small margins of differential tax burdens for taxpayers with high incomes residing in different States, the latter is not true for taxpayers with low incomes and relatively low taxes. Thus, with an effective rate of 4 percent in both State and Federal laws, mutual deductibility would leave a total tax burden of 7.68 percent in an income-tax State as compared with 4 percent in a non-income-tax State.

However, the appearances are again deceiving. The relatively low prevailing State rates and the operation of a progressive scale, which causes the deduction to be applied at a higher rate than the effective one, lead in actual practice to very much smaller differentials than the above illustration suggests. The difference in tax actually payable by a married taxpayer, without dependents and with a $5,000 income, in New York as compared with Pennsylvania (a non-income-tax State), is only 1.1 percent of the net income even though New York allows no deduction for the Federal tax. However, in this case 1.1 percent of net income is 14.7 percent of the total income tax in a non-income-tax State.

The size of the differential, expressed as a percentage of an effective rate on income, is a function of several variables. It is smaller under reciprocal than under unilateral deductibility. Obviously, it also varies with the height of the State rate structure. Low State rates cannot produce large differentials, in terms of total income, between

INCOME TAX LIABILITY FOR A MARRIED MAN WITHOUT DEPENDENTS, UNDER 1941 FEDERAL AND NEW YORK STATE RATES UNDER VARIOUS ASSUMPTIONS

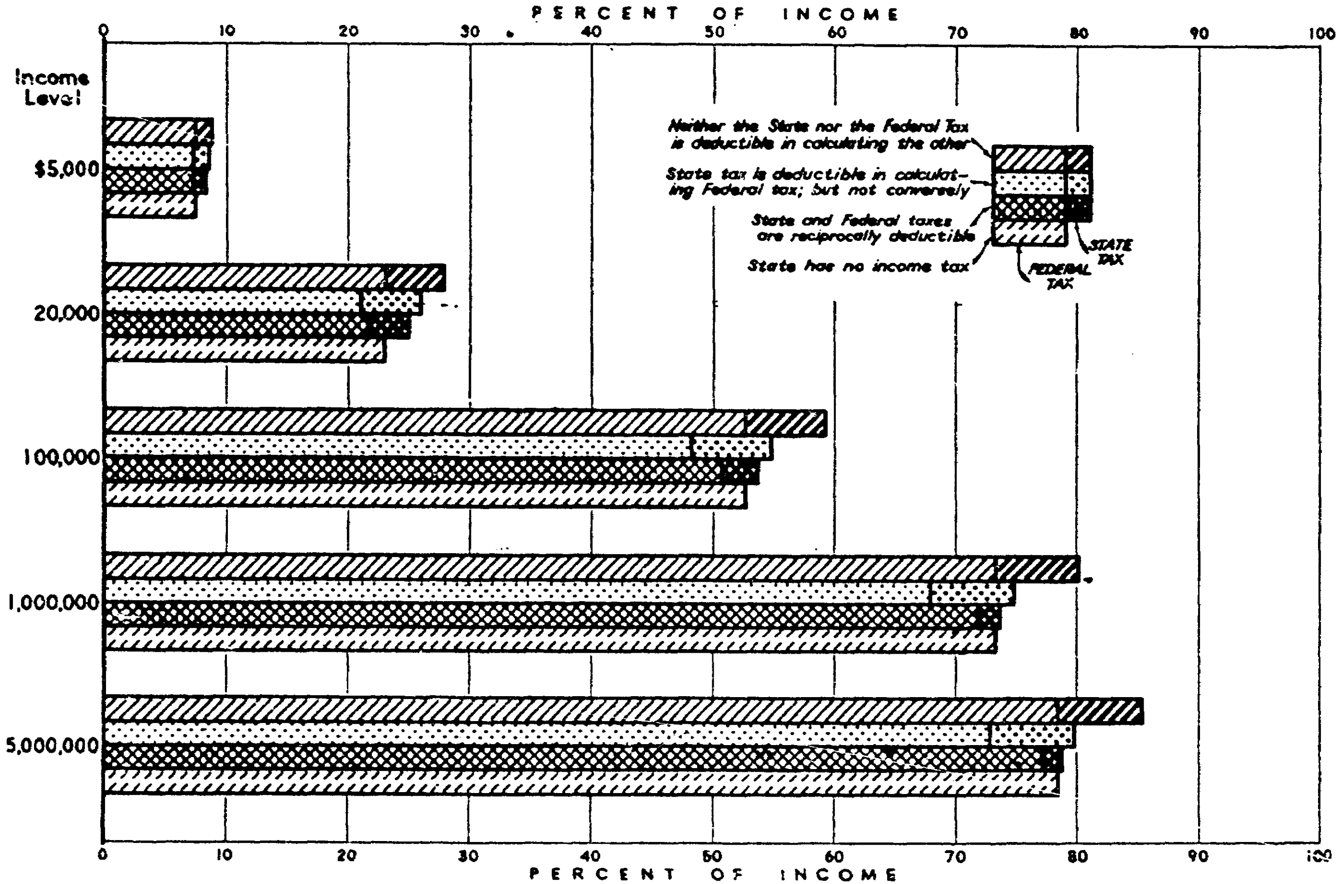

CHART 12.

residents of income tax and non-income-tax States under any circumstances. Finally, the differential varies inversely with the height of the Federal rates. As the entire Federal rate structure moves upward, for example, from the 1940 schedule to that of 1941, the size of the differential at every income level decreases. Within the same Federal rate structure, the size of the differential, measured as a percentage of income, decreases after a certain point, where the rising Federal rates "overwhelm" the constant State rates. The location of this point depends roughly on the income level at which graduation in the State rates ceases.

Not only the effective rate of the taxpayer's differential but also the absolute amount of the differential may be smaller for a wealthy taxpayer than for a poorer one. For example, the net additional burden imposed by the Delaware personal income tax upon a single person with an income of $70,000 in 1936 was $777 while that on a person with an income of $100,000 was only $719.[87]

The influence of deductibility, unilateral or reciprocal, in diminishing taxpayers' income tax differentials carries a significant corollary with it: The combination of State and Federal rates cannot be confiscatory, so long as neither rate is independently confiscatory, i. e., each rate is less than 100 percent.[88] This proposition holds true regardless of whether the rates are effective rates or whether they apply only to the top brackets of the income. When Federal rates are high, the combined Federal and State effective rate, given reciprocal deductibility, scarcely exceeds a Federal effective rate which takes no account of State taxes.

The Federal deductibility feature is tantamount, in one sense, to a Federal subsidy. A portion of the State tax can be said to be offset by a reduction in Federal tax resulting from the deduction of the State tax in the calculation of Federal tax. The "subsidy" still holds true, but to a lesser extent, where reciprocal deductibility is extended by the State to the Federal levy; the Federal Government collects less revenue on the same income in a State with an income tax than in a non-income-tax State.[89] Thus the deductibility provision in the Federal law not only protects the taxpayer but also gives a substantial advantage to the income-tax States.

Of the Minnesota State tax collected on the $20,000 income of a married man without dependents, a portion will come from the Federal Government in the sense that the Federal Government will collect less from this individual than it would if he lived in a non-income-tax State; a portion will come from the taxpayer in that his total income-

[87] Twentieth Century Fund, Studies in Current Tax Problems, New York, 1937, p. 70. This anomaly results from the fact that the progression of the Delaware tax rates stops at a relatively low level, $10,000. As net income increases, the Federal tax rate increases, and the influence of a constant effective State rate in reducing the effective Federal rate of tax increases. This process tends to reduce the taxpayer's interstate differential, unless a highly progressive State rate structure counteracts the influence of the graduation in the Federal rates. Since graduation ceases early in most State rate structures, a declining differential, expressed as a percent of income, is assured. Whether the declining effective rate turns into a declining absolute sum, expressed in dollars, depends on the relation between the rate of decline of the differential and the rate of increase of the net income. If the former rate is greater, a decline in absolute magnitude occurs. Given constant or mildly graduated State rates, the rate of fall in the differential, expressed as an effective rate of income, is primarily a function of the rate of increase in the Federal surtax rates. The differential will therefore decline in absolute magnitude if the rate of increase in the Federal rates exceeds the rate of increase in net income.

[88] In cases of extreme fluctuation of income from year to year, this statement does not hold true. (See p. 443.)

[89] The factors influencing the results are the height and steepness of progression of the two rate scales (Federal and State) and the provision for deductibility (i. e., whether deductions are reciprocal or unilateral and if unilateral whether the deduction applies to the higher and steeper tax or vice versa). Irregular progression of the two rate scales may lead to very erratic results in the application of the deductibility privilege at different income levels.

tax bill will be greater in an income-tax than in a non-income-tax State. Under the 1941 law, the Federal share of the Minnesota State income tax on the $20,000 income is calculated to be 40 percent and the taxpayer's share 60 percent (table 56). This means that the Federal Government has in effect reduced the burden of the State income tax to the taxpayer by nearly half, and that the State in effect has received this as a differential subsidy from the Federal Government. At the $1,000,000 level, the Federal share of the Minnesota State tax was 79 percent.

TABLE 56.—*Percentage participation of Federal Government and taxpayer in State income tax in California, Minnesota, and New York, at selected net income levels* [1]

Net income	California		Minnesota		New York	
	Federal share	Taxpayers' share	Federal share	Taxpayers' share	Federal share	Taxpayers' share
1. UNDER ASSUMPTION OF UNILATERAL (FEDERAL) DEDUCTIBILITY						
(a) In 1941:	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
$3,000	0	100	0	100	0	100
$5,000	20	80	17	83	15	85
$20,000	45	55	40	60	41	59
$100,000	68	32	68	32	68	32
$1,000,000	79	21	79	21	78	22
$5,000.000	81	19	80	20	80	20
(b) In 1940:						
$3,000	0	100	0	100	0	100
$5,000	0	100	0	100	8	92
$20,000	20	80	21	79	22	78
$100,000	57	43	57	43	58	42
$1,000,000	76	24	76	24	76	24
$5,000,000	78	22	78	22	77	23
2. UNDER ASSUMPTION OF RECIPROCAL DEDUCTIBILITY						
(a) In 1941:						
$3,000	0	100	0	100	0	100
$5,000	25	75	10	90	18	82
$20,000	45	55	42	58	42	58
$100,000	67	33	68	32	67	33
$1,000,000	80	20	79	21	79	21
$5,000,000	82	18	83	17	81	19
(b) In 1940:						
$3,000	0	100	0	100	0	100
$5,000	0	100	0	100	0	100
$20,000	19	81	21	79	21	79
$100,000	58	42	62	38	62	38
$1,000,000	76	24	76	24	74	26
$5,000,000	77	23	77	23	78	22

[1] The taxpayer is a married man without dependents; the community property law in California is disregarded; the tax credit in Minnesota is converted into a $2,000 deduction from income.

(*b*) *Problem of variable income.*

The discussion of tax deductibility in this section assumes that the tax payable to one jurisdiction and the tax deductible in computing the tax for the other jurisdiction are equal in amount. That is, the taxes owed to both jurisdictions are computed on the income of the same year.

The requirement for the fulfillment of this assumption in fact is one of two alternatives: Tax accounting on an accrual basis or a joint Federal-State tax return. The latter alternative is the more convenient and quite practicable under joint or unilateral administration of both taxes. The computation of both taxes would be very simple under unilateral deductibility; it would be more complicated and would perhaps require the use of tables under reciprocal deductibility.

Under present conditions, this assumption is not valid. Actually, in computing the tax for one jurisdiction the tax deducted is not the current liability to the other jurisdiction, but the tax paid to the other jurisdiction the previous year. If income receipts were constant over time, this year's and last year's taxes would be equal, given constant rates, and the deduction would also be the same. However, incomes are not constant. In extreme cases, where income oscillates between an amount so small as to be exempt (or losses) and a very large amount, the mitigating influences of deductibility hitherto outlined are completely nullified. In the year of maximum income, the taxpayer has no deductions available, because he paid no taxes the previous year. In the year of small income (or losses), the deductions are available, but there is little or no income against which to offset them, and no tax. Since the negative items cannot be carried over, they are of no assistance. The taxpayer's combined tax liability in the years of high income would equal the sum of the liabilities to both jurisdictions indicated by the nominal rates, and could be confiscatory. Under a progressive rate structure, the fluctuations in income need not be as extreme as this in order to reduce the effectiveness of tax deductibility as a minimizer of interstate tax differentials. If income has risen, the available deductions are small, and insufficient advantage is taken of the high top tax rate. If income has fallen, the deductions are large, but are taken at the low top rate applicable to smaller incomes. Since the size of the interstate differential varies directly with the size of the deduction and the rate applicable to it, it follows that the differential is always larger when income fluctuates than when it is constant, if the tax deduction taken in computing one tax is not equal to the tax, computed on the same income base, currently paid to the other jurisdiction.[90]

To mitigate the difficulty arising from changes in income and in tax rates, it is recommended that taxpayers be allowed to report taxes on an accrual basis even though other expenses are on a cash basis. This would mean that the taxpayer in his Federal return would report his State income tax due and payable at the time of reporting rather than the cash outlay for income tax purposes during the previous year.

It is apparent that the encroachment of the new Federal tax upon the State income tax base will be quite substantial in those States that allow the Federal tax as a deduction. It will not affect the other States. Whether or not, in the case of the former, the upward trend of State income tax receipts will persist, is a question which cannot now be answered.

(c) *Deductibility of corporation taxes.*

The Federal excess-profits tax has introduced into the corporation income tax those elements that are apparently prerequisite to the significant operation of tax deductibility that aims at the equalization of tax burdens between income-tax and non-income-tax States, and consequent assurance of a nonconfiscatory combined tax liability. The requisite elements are a high ratio of Federal to State effective tax rates and steep graduation in the Federal tax.

[90] No corroborating computations are offered, because no reasonable criterion exists by which to vary all individuals' income from year to year. Stated qualitatively, the proposition of the text appears to be well established.

Usually, the ends sought by deductibility can be roughly achieved by a unilateral (Federal) grant, if steep graduation in the Federal tax prevails. The case of the Wisconsin individual income tax has shown, however, that unilateral deductibility (or more correctly, a strictly limited reciprocal grant) falls far short of eliminating the differential for taxpayers in different States when the Federal-State tax ratio is too low. Only reciprocal deductibility will achieve the stated end in this instance. The fact that unilateral (Federal) deductibility generally suffices, indicates that a high Federal-State tax ratio is generally implicit in the actual facts.

In the absence of steep graduation of the Federal tax rates, under which the rate applied to the deduction is higher than the effective rate on the entire income, no substantial equalization in burdens between taxpayers of the income-tax and non-income-tax States can be achieved, unless the Federal rates are exceedingly high. In the absence of an excess-profits tax, the Federal rate structure on the income of corporations can be regarded as flat. Under such conditions, if the State tax rate is 6 percent, it takes a Federal rate of 83 percent to diminish the interstate taxpayer differential to 1 percent under unilateral deductibility, and a Federal rate of 60 percent to accomplish the same end under reciprocal deductibility. Of course, a Federal rate structure that is graduated by brackets would have to ascend to the same high rate levels in order to achieve similar minimization of tax differentials. However, only the bracket rates need go so high. The effective rates can be much lower.

Since the Federal corporation income-tax rate was only 31 percent in 1941, it could not by itself reduce the interstate tax differential on a State rate of 6 percent below 2.9 percent, even under reciprocal deductibility. In the absence of an excess-profits tax, reciprocal deductibility is not an efficient instrument of Federal-State coordination in the corporation tax field. The excess-profits tax, prior to the Revenue Act of October 1942, introduced progression up to 60 percent. But its effectiveness in minimizing tax differentials has been enhanced by the method of computing it ahead of the corporation income tax. Even though the excess-profits tax and the corporate-income tax of a given corporation may be near equality, the base of the excess-profits tax to which relatively high tax rates are applied may be considerably smaller, after subtracting the credit for normal earnings, than the base for corporate income-tax purposes. The deduction of the State tax from the small and well-exploited base is of greater consequence than a similar deduction from a larger base taxed at lower rates. The excess-profits tax serves to reduce the interstate tax differentials of corporations because it bears the brunt of the State tax deduction.

(*d*) *Arguments and conclusions concerning deductibility for personal income taxes.*

The advisability of permitting the deduction of personal income taxes may be questioned. In the first place, it warps the pattern of the progressive rate scales of the two taxing authorities. The illustration given above for the Delaware tax indicates that an apparently progressive State tax may become regressive under certain conditions. It is true that the Federal tax will offset this to the extent that the combined taxes will retain a modified rate of progression, but the State system itself will lack the progressive element that the

State income tax was intended to provide. This criticism is not serious, in view of the fact that the State levy will be progressive in the lower brackets, which contain most of the incomes, and where a system of progressive taxes is of the greatest consequence. And the rate modifications in the higher brackets may be needed both to prevent confiscation and to prevent migration of the tax base for the sake of tax avoidance.

Moreover, whether a State income-tax scale is progressive depends on what is accepted as the base—net income, or net income after Federal taxes. If it is the latter that is selected, the deductibility feature cannot be said to interfere with progression. It is true that State provision for the deductibility of Federal taxes tends to make the State income tax less progressive but the resultant combined Federal and State tax liability may more closely represent popular intent than would be the case were deductibility disallowed by the States.

A second, and more serious, criticism of such deductions arises from the fact that it is the preceding year's tax that is deducted, and this may, as has been shown, result in very different taxes for two taxpayers whose circumstances are identical in every respect except that the income of the first has increased (or he has moved from a non-income-tax State), whereas the income of the second has remained unchanged. Because of this, deductibility does not offer certain protection against confiscation, and introduces differences in burdens between taxpayers with equal current incomes that have no relation to ability to pay. Change to an accrual basis of reporting taxes, as previously explained, would answer this objection.

It is sometimes argued in favor of income-tax deductions that they conform to the usual practice of deducting other taxes in computing income for tax purposes. The allowance of any nonbusiness taxes can be challenged, however. Sales taxes on goods for personal consumption might well be regarded as an integral part of the cost of living; and the deduction of the home owner's property taxes, but not the rent paid by the tenant, is a clear inequity in the income taxes now in force.

Personal income taxes are in a different category. Whether or not deduction is allowed for personal income taxes, individuals of the same income in the same State will be taxed equally whether they own their own homes or not, and whether they spend or save. The deduction will distinguish between them only insofar as their incomes in the previous year differed from one another. This point, which has already been discussed, argues against deduction. The comparison with practice in regard to other taxes provides no arguments for or against deduction of income taxes.

The case for deduction of income taxes is based mainly on opportunistic grounds. As long as there are States with relatively low personal income taxes, or no personal income taxes at all, mutual deductibility—or at least the privilege of deducting the State tax for purposes of Federal income taxation—affords some protection from interstate competition to those States that wish to maintain a progressive element in their tax systems. And as long as State and Federal Governments determine their rates without adequate consideration of the effect of each other's levies, provision for deduction of the preceding year's taxes will usually protect the taxpayer from confiscatory levies.

Less variation in State income taxes, and Federal and State rate scales adjusted to impose a reasonable total burden might be better. But in the absence of such adjustments the Federal Government can protect and encourage the States that wish to levy substantial personal income taxes by the provision for deducting State taxes. And the States, in turn, can reduce competition from other States by the provision for deducting Federal taxes. In the long run this may encourage more States to introduce the tax, if they are unable to attract wealthy residents by income-tax exemption; and it may check demand for withdrawal of the States from the field.

The opportunistic arguments advanced for the deduction of Federal and State taxes, respectively, in determining personal income tax liability, apply also for corporation income taxes. The threat of migration from high- to low-tax areas is heard even more frequently for corporations than for individuals; and if actual changes in the location of industry occur solely because of the tax differential, the resulting industrial organization will tend to be less efficient and losses will accrue to the Nation as well as to the State.

Because of the deductibility features of Federal and State income-tax laws, the Federal Government can and should feel free to order its wartime income-tax schedules without much regard to present State levies or possible changes in the latter. The Federal Government might even go so far as to make deductibility of State income taxes conditional on reciprocal State deduction of Federal income taxes.

(e) *Reciprocal deductibility.*

Were the Federal Government to adopt a reciprocal deductibility provision with regard to the individual income tax, granting the deduction of the State income tax in computing the Federal tax only to residents of States that grant the deduction of the Federal tax in computing the State tax, two situations might develop: (1) The States that now deny deduction of the Federal tax might reverse their policy and grant deductibility, (2) these States might persist in their present policy.

The revenue effects of the two alternative possibilities follow:

1. Revenue effects of change in policy by States currently not allowing deduction of the Federal tax (based on 1941 rates):

[In millions]

	Loss to States	Federal gain	Taxpayers' gain
Fiscal year 1942	$36	$14	$22
Fiscal year 1943	85	32	52

2. If the States that now deny deductibility refuse to change their policy, a reciprocal provision would require the Federal Government to disallow deductibility of State income taxes to residents of these States. There would result a Federal revenue gain of $50 millions for fiscal year 1942; of $77 millions for 1943.

Complete abandonment of deductibility by the Federal Government would yield an increase in revenue of $65 millions for fiscal year 1942, $100 millions for fiscal year 1943.[91]

An analysis of the effects of a reciprocal deductibility provision in the Federal income-tax law must consider two alternatives: A. The States not now allowing deductibility of Federal income taxes will modify their laws so that such deductibility is allowed. B. The States will not modify their laws.

Under alternative A, the reciprocal deductibility provision in the Federal law could be supported on the grounds that:

1. All income taxes would be based upon income after taxes, that is, disposable income.
2. Differentials between total income taxes paid upon similar incomes received in income-tax and non-income-tax States would be reduced to a minimum.
3. While the Federal Government would still collect more from an income in a non-income-tax State than from a similar income (before taxes) in an income-tax State, the differential would be less than at present.
4. The Federal Government would be freer to press its income-tax program and could get the maximum revenue from such program.

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[91] Technical explanation of derivation of estimates:

A. Estimate of the revenue effects of the granting of deductibility by the States now denying it.

1. *Loss to the States.*—(*a*) The State revenue losses for 1942 are a function of Federal income-tax collections in these States for 1941. The State losses for 1943 are a function of Federal collections in 1942.

(*b*) Federal income-tax collections in the nondeductibility States are estimated at $600 millions in fiscal year 1941, and $1.4 billion in 1942.

(*c*) Each of these amounts is multiplied by 6 percent.

(*d*) This percentage is based on computations made by the Wisconsin Income Study (Wisconsin Individual Income Tax Statistics: 1936 Income, Wisconsin Tax Commission, vol. I, p. 38). It has been adjusted (increased) to take account of the higher Federal rates now prevailing in the middle income brackets, which, in turn, result in higher Federal tax yields from these brackets. Medium-sized incomes are taxed near the maximum State rates.

(*e*) The indicated revenue losses to the States are $36 millions in fiscal year 1942 and $85 millions in fiscal year 1943.

2. *Federal gains.*—(*a*) The loss to the States is to be divided into gains accruing to the Federal Government and to the taxpayers.

(*b*) The Federal share is obtained by imposing a tax upon the larger disposable income remaining with the taxpayer after he pays the smaller State tax following the enactment of a deductibility provision by the State.

(*c*) The State loss is apportioned by income classes according to the distribution of Federal tax deductions claimed in Wisconsin in 1936, classified by net taxable income (Wisconsin Income Study, ibid., p. 39).

(*d*) The resulting sums are multiplied by the Federal tax rates.

(*e*) The product is a minimum estimate of the value of the Federal share of the State loss. However, since the amount of State taxes paid by any one taxpayer is not large, the gain before Federal taxes cannot be great enough to extend over too many tax brackets. Therefore, this minimum estimate is an acceptable approximation of the figure sought.

(*f*) The effective Federal tax rate is 38 percent.

(*g*) The indicated gain in Federal revenue is $14 millions in fiscal year 1942 and $32 millions in fiscal year 1943.

B. Estimate of the gain in Federal revenue, if the Federal Government denies deduction of State income taxes to residents of the nondeductibility States.

(*a*) The gain in Federal revenues for 1942 is a function of the State income tax collections of the non deductibility States in 1941; and for 1943, it is a function of their collections in 1942.

(*b*) Individual income-tax collections for these States in 1941 were $175 millions out of total State individual income-tax collections of about $230 millions.

(*c*) The $175 millions is allocated according to the distribution of normal income-tax collections by net taxable income classes for Wisconsin in 1936 (Wisconsin Income Study, ibid., p. 28). An upward adjustment for the brackets above $100,000 is made.

(*d*) The Federal rates, surtax plus normal, are applied to the new distribution. The product is a minimum estimate.

(*e*) The indicated revenue gain to the Federal Government is $50 millions for 1942.

(*f*) Based on the procedure outlined above, the estimated gain in Federal revenue, if deduction of the State income tax were denied to residents of all States, is about $66 millions.

Objections to a Federal provision requiring reciprocal deductibility are:

1. Certain States would thereby suffer a very considerable revenue loss, substantially more, in fact, than the Federal Government would gain.
2. States would be required to modify their laws and in some cases might have to call special sessions of legislatures for that purpose.
3. The effective rate of State income taxes in the nondeductibility States would become less progressive than at present.

Under alternative B, above, the results would be much less desirable. Combined Federal and State rates would approach the confiscation point in some instances and differential burdens on incomes realized in different States would be much increased.

On the whole it seems inadvisable to press the conditional reciprocal deductibility proposal, though it may be held in reserve in case States develop their income taxes to an extent which causes serious embarrassment in the Federal program. It is recommended that, as soon as revenue needs permit, States not now allowing reciprocal deductibility change their statutes to allow it.

Besides the deductibility feature, means of coordination suggested for the income-tax field include: (1) A Federal credit for State income taxes paid; (2) sharing of revenues; (3) separation of sources (including division of the field); (4) elimination of dual administration; and (5) State supplementation and Federal action to avoid multiple taxation.

6. THE TAX CREDIT

The enactment of a credit for the income-tax field similar to that applied to death taxes has received widespread support.[92] It is expected that the possibility of securing additional revenue without simultaneously increasing the taxpayer's burden would tend to induce the States to adopt an income tax. A painless tax eliminates all concern regarding comparative tax burdens among the States and diminishes the fear of interstate tax-induced migration. If the Federal credit becomes accepted as the maximum State tax levy, just as it is reasonably certain to be the minimum, all income tax differentials disappear, along with their alleged consequences.

Suggestions for the implementation of the credit are diverse. It has been proposed as an independent instrument directed toward promoting the universal adoption of the income tax by the States: The Federal Government is to underwrite a minimum of direct taxation and progression in the State tax systems.[93] As such, it leaves unsolved the problem of dual administration. Others have urged that credit also be employed to promote fiscal reforms, conditioning the grant of the credit upon the meeting of certain requirements by the States.[94] The credit would then hinge upon the acceptance by the States of Federal administration or of Federal determination of juris-

[92] Cf. Walter W. Heller, State Income Tax Administration, unpublished doctoral dissertation, Madison, Wis., 1941, pp. 325-329; Harold M. Groves, "The Scope of State Income Taxation under Present Conditions," Proceedings of the National Tax Association, 1935, p. 145; Robert Murray Haig, "Coordination of the Federal and State Tax Systems," Proceedings of the National Tax Association, 1932, p. 225. Mark Graves favored the crediting device in 1932.

[93] Harold M. Groves, "Uniformity in State and Local Taxation," Current Problems in Public Finance, New York, 1933, p. 285.

[94] Cf. Heller, op. cit., p. 303; Discussion by T. S. Adams in Proceedings of the National Tax Association, 1931, p. 345; Robert S. Ford, The Allocation of Corporate Income for the Purpose of State Taxation, Albany, 1933, p. 12.

diction to tax, or of Federal definitions of situs and domicile, the objective of which would be the elimination of double taxation.

The credit receives considerable support in lay and textbook discussions of tax coordination. In these circles the principal objection against it is its tendency to coerce, rather than to persuade, the sovereign States into actions which they might not undertake voluntarily.[95] They charge the mortal sin of impairment of State rights against a measure which actually makes it profitable for the States to enact what are widely believed to be the most equitable of all tax laws. If, in addition, certain conditions must be met to qualify for the credit, the sin is not committed once but repeatedly.

Others do not base their opposition to the credit on absolute notions of State rights. They recognize that while the States are sovereign for local police purposes, they are not for other purposes. The very fact that they are federated into a greater union proves that they have been deprived of some of the powers of sovereignty. The significant problem is the demarcation of the powers retained by the States from those surrendered. This is to a large extent, of course, a problem of legal interpretation. But legal interpretation exceeds the limits of *stare decisis*. It recognizes the economic, social, and political phenomena of the real world which furnish the problems and the facts handled by the legal process. If the commerce and industry and population movements of this country have taken on a complex Nation-wide character, the safeguarding and promotion of this development becomes a national responsibility. If the economic system is beset by multiple tax burdens, compliance and administrative costs, and by upsetting differentials, it is the duty of the Federal Government to remove these obstacles to economic activity and progress.[96] It is not an impairment of State rights to create conditions under which the States will find it advantageous to cooperate and to enact and enforce desirable measures, which in the absence of such conditions do not appeal to the self-interest of the individual States.[97] This is not to deny, however, that insofar as practicable local responsibility should be preserved.

Viewed in the light of this fundamental political question, it appears that the credit is not an extreme federalizing device. While it exerts some pressure toward uniform behavior by the States, it reserves considerable freedom of action to them. An unconditional credit leaves the entire process of tax collection and also of expenditure with the States. If used conditionally, as an auxiliary to some other major proposal, it had best be judged in the light of that proposal.

The advocates of Federal responsibility in the economic sphere concentrate on technical objections against the credit. One study, which examined the possibilities of Federal administration of a State supplement to the individual income tax, emphasizes the difficulties involved in formulating a reasonable rate structure for a credit, and the inevitable complexity of the result.[98] Before the Federal income-tax

[95] L. W. Mattersdorf, chairman, "Report of the Committee of the National Tax Association on the Allocation of Income," Proceedings of the National Tax Association, 1938, p. 491. The committee rejects uniformity in the allocation of income that would be achieved by means of a Federal credit because it would impair the sovereignty of the States, an essential attribute of which is the power to tax.

[96] "* * * The Federal system ought to supply somewhere within itself an adequate remedy for all serious frictions caused by the Federal system." (A. Chafee, Jr., "A Comment on the Report of the Committee on Double Domicile in Death Taxation," Proceedings of the National Tax Association, 1940, p. 259).

[97] *Steward Machine Co.* v. *Davis* (301 U. S. 548 (1937)).

[98] Confidential study, Treasury Department, Division of Tax Research.

exemptions were lowered in 1940 and 1941, it was a generally accepted view that, while the Federal Government should exploit the high-income field, the low-income field properly belonged to the States. This division presumed small incomes to be local in origin and large incomes to be derived from national sources. The division of incomes at some level into local and national provided the logical foundation for a proposal that the States tax only incomes below $5,000 or $10,000 and the Federal Government tax the remainder. This consideration has been the basis of some proposals for separation of sources in the income-tax field. However, the division also carried implications for a credit policy. If the States have a right to tax the small incomes only, the credit cannot be a flat percentage of the Federal income-tax liability. Rather, it must consist of a regressively graduated tax structure, which is quite complex and varies with changes in the Federal rate.

If a Federal credit is used in conjunction with independent Federal and State administration, the rate problem just outlined is insoluble. But there is no reason why the rates of the credit could not be incorporated in the Federal statute in a simple manner, if a unitary income-tax-rate structure is agreeable. It could provide for a credit of 1 percent on the first $1,000, 2 percent on the next $1,000, etc., up to $5,000 or $6,000. This credit could automatically be remitted to the State, once the jurisdictional question were resolved. It will be noted, however, that simplicity is bought at the price of considerable federalization, even uniform personal exemptions being necessary.

Granting for the moment the possibility of a simple rate structure for the individual income-tax credit, another student of public finance is dubious of the feasibility of a corporation income-tax credit.[99]

> The technical problems involved in an extension of the crediting device to such fields as that of the Federal corporate income tax have thus far received practically no consideration or discussion. Before such a credit can be seriously urged, satisfactory answers must be found to many difficult questions. Assume that the rate of the Federal tax has been agreed upon and also the extent to which the State taxes shall be considered valid for crediting purposes. What type of State corporation taxes shall be recognized as offsets against the Federal tax? Must they be *net* income taxes? Shall a tax which stresses corporate excess as well as net income, like the Massachusetts tax, or a tax which provides for a flat minimum and a low capital stock alternative, like that in New York, be deemed acceptable? What would be the status of a State net income tax with an alternative tax on gross such as has been suggested in New York?

However, the problem of what kind of State tax should come within the orbit of the credit may not be as difficult to solve as Haig suggests. The Federal statute providing the credit can also define its scope, and the States would probably adapt their laws to the Federal definition.

It seems that the critical objections to the credit device are three:

First, if the credit is to be sufficiently simple to be practical, it leads to much federalization—more, in fact, than results from other coordinating devices which are on their face more centralizing. A State supplement to a Federal tax does not require uniform State rates and personal exemptions; the successful operation of a credit practically does, if a great deal of complexity in compliance and of duplication in administration is to be avoided. Furthermore, a credit is more coercive in its effects than is the supplement, since its pecuniary inducements are greater.

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[99] Robert M. Haig, "The Coordination of the Federal and State Tax Systems," op. cit., p. 230.

Secondly, with fewer than two-thirds of the States levying income taxes, a credit would prove costly to the Federal Treasury.[1] An acceptable credit formula must not diminish the revenue of the present income-tax States. Such a formula would also produce considerable revenue for the present non-income-tax States, at the expense of the Federal income-tax yield. The Federal Treasury cannot reimburse itself by raising the rates and lowering the personal exemptions, since presumably it has already exerted the maximum effort in these directions. The time might come when the Federal Government could afford this loss of revenue, but the convenient moment is likely to be always in the future.

Finally, and most important, the end toward which the credit is primarily directed, the elimination of interstate differentials, is to some extent realized by the reciprocal deductibility of Federal and State income taxes or even by a unilateral grant of deductibility by the Federal Government. Undue complexities and pressures on the States are avoided, without the apparent loss of any desirable goals.

7. SEPARATION OF SOURCES

Separation of sources contemplates an abandonment of the income-tax field by either the Federal Government or the States. This is not likely to happen without coercion or compensation, both of which would involve more problems than the program would solve. Division of the field might be effected through a reciprocity clause in the Federal income tax providing an exemption for all incomes under $10,000 reported from States in which the tax laws exempt incomes over $10,000. However, this program, equivalent in many respects to a tax credit of 100 percent for State income taxes in low brackets, ignores the degree to which States plow their income-tax fields. Moreover, the Federal Government would hardly sacrifice such a large part of the income-tax field as this demands. It will be noted that reciprocal deductibility, while doing considerably less violence to the Federal Treasury, does to some extent accomplish a division of the tax base. It might also be argued that the Federal Government is sharing a larger part of the tax on high incomes than on low, since reciprocal deductibility reduces the effective State rate on the higher brackets more than on the lower brackets.

8. FEDERAL COLLECTION AND STATE SHARING

Some students of taxation regard as hopeless the possibility of reconciling the conflicts between the Federal and State income taxes, and of eliminating the confusion in the State income-tax field itself. Recognizing the substantial advantage which the Federal Government possesses in the income-tax field, they would assign this source to the Federal Government to collect. Provision would then be made "for such a division of yield with the States as is appropriate to the func-

[1] The fact that many States still do not impose income taxes has been urged as an indication of their prospective resentment if a credit is enacted. (See Haig, "Coordination of the Federal and State Tax Systems," op. cit., p. 72.) However, such resentment did not prove a basis for serious opposition to the pecuniary inducements of the death-tax credit.

tions assigned to them on the basis of the principle of efficiency." [3] Most of the proponents of sharing have visualized some return to the States on the basis of origin. The objections to the sharing technique have been discussed in an earlier section. It involves a large sacrifice of State independence, little or no adjustment to the revenue needs of the States, and distribution of nationally created income to localities in which it is realized. Like the income credit, it involves (in effect) universalizing a State tax now utilized by only two-thirds of the States. Much more, perhaps, could be said for a distribution through the system of grants-in-aid. We already have such a system, partially developed, and a further development is here recommended. But the grants-in-aid system does not need to contemplate State withdrawal from the field of income taxation entirely. It merely softens the pressure of State needs for revenue and makes it unnecessary for them to plow the income-tax field as intensively as they otherwise would.

9. ELIMINATION OF DUAL ADMINISTRATION

By far the most promising approach to coordination in the income-tax field is from the angle of administration. As previously observed, a sound precedent for delegated administration has developed in both Canada and Australia, and the possibilities of joint administration have been suggested as an improvement over these successful experiments. To be sure, 6 States, as in Australia, find it much easier to work out cooperative arrangements than would 48 States in the United States. But, fortunately, cooperation in administration can move forward by degrees. Some cooperation has already been achieved in the United States. Utilization by the States of Federal income-tax information is already developed to some extent and some informal cooperation between administrative staffs now occurs. But the field has scarcely been scratched. Joint returns, joint audits, joint use of personnel, more uniform laws, are a few of the possibilities. As previously suggested, a Federal-State Fiscal Authority could do much to facilitate development in this field. Moreover, the broad jurisdictional authority and the administrative facilities of the Federal Government are needed, also, to uncover and to levy upon many income sources currently escaping taxation.

10. SUPPLEMENTATION AND STATE AND FEDERAL ACTION TO AVOID MULTIPLE TAXATION

Closely related to, and scarcely distinguishable from, joint administration is the idea of State supplements to the Federal income tax. This implies mainly single administration and uniformity of application. Joint administration would develop toward both of these goals.

[3] Robert M. Haig, "The Coordination of The Federal and State Tax Systems," op. cit., p. 230. In order to give the Federal Government a free hand in monetary control, Henry C. Simons advocates Federal collection and State sharing (Personal Income Taxation, 1939, p. 214). In order to solve the complex problem of allocating income, Robert S. Ford came to the same conclusion with regard to the corporate income tax (The Allocation of Corporate Income for the Purpoes of State Taxation, Albany, 1933, p. 121). Edwin R. A. Seligman was a persistent proponent of Federal administration (The Income Tax, New York, 1911, p. 656). Clarence Heer also favors Federal collection with some distribution to the States ("The Place of Personal Income Taxes in a Modern Fiscal System," The Annals of the American Academy of Political and Social Science, vol. 183, January 1936, p. 84). Mabel Newcomer favors central collection but is skeptical of sharing as a basis of distribution, contending that the latter is likely to lead to inefficiency and waste and that it unduly favors the wealthy districts ("Fiscal Relations of Federal, State and Local Governments in the United States," Proceedings of the National Tax Association, vol. XXXIII, No. 198, 1940, p. 201).

(*a*) *Uniform definition of income.*

American income-tax laws are all based upon the same fundamental conception of net income: Income is the accretion in economic power. On the whole, the statutory definitions and interpretations of net taxable income in the several States are not very dissimilar from each other or from that of the Federal Government. But there are enough specific differences to plague a taxpayer with income sources in more than one State, and these differences would prove even more troublesome to an administrator charged with the execution of 35 laws, in both their substantive and procedural aspects.

Net taxable income is the resultant of a process of refinement. From gross receipts, certain items are excluded, others are deducted, and finally personal and dependents' exemptions are allowed. The remainder is generally the tax base; but the base itself may be divided into several portions, each of which is treated as a distinct tax base, as in Massachusetts. The rates applied to the tax base are usually graduated progressively by brackets; but they may be graduated by total income, or may even be flat.

One organization could not and would not undertake to handle the many different provisions of the laws now in existence, which are supposed to pertain to the same taxable subject. Its personnel could never acquire the requisite expertness, would become bogged down, and never get beyond checking the initial and most obvious filing requirements. The overhead economies of unitary administration would not materialize in the absence of large standardized tasks conducive to specialization. Rather, a loss in revenue yield would probably follow. To obtain the benefits of unitary central administration, the States must agree to adjust their tax bases, for the most part, toward a common standard. While personal exemptions and rates, and perhaps one or two other items, might be exempted from the requirement of uniformity, exceptions with respect to procedural or technical matters are much more doubtful. Short of any attempt at single administration, uniform filing requirements, penalties, and depreciation and depletion allowances are quite desirable. Likewise, viewed from the compliance aspect, unitary administration of diverse laws has little to recommend it.

Since the basic conception of income is the same all over this country, it is perhaps not too great an abridgement of the freedom of the States to expect uniform constructions of this basic conception. In a sense, diverse interpretations of a basic idea constitute technical diversities, which should always yield to considerations of substance.

While unitary central administration requires uniform statutory and regulatory provisions, the converse also holds. Uniformity in law may well be viewed as a desirable end per se, promoting convenient compliance, cheaper administration, and smaller tax differentials. A set of uniform laws is most efficiently administered by one organization.

A high degree of procedural and technical uniformity is the sine qua non of unitary administration. Substantive provisions may be diverse, however, if the diversity is not overwhelming. Given a uniform definition and interpretation of income, experimentation with the level and type of personal exemption and with the level and type of rate would not be undesirable. As previously explained, reciprocal tax deductibility reduces the factor of interstate competition to acceptable proportions. Thus, the tax could be adjusted to suit the revenue needs of the State, and to heed the local political climate regarding the desirable degrees of progression and direct taxpayer participation in government.

In practice, the taxpayer would start with a uniformly determined net income figure to which he would apply the personal exemption and rates enacted by the State of jurisdiction. To further the convenience of the taxpayer and the efficiency of the administrator, these calculations could be performed on a joint Federal-State return.

(b) *Multiple taxation and jurisdiction.*

Considerable discussion of the multiple taxation and other jurisdictional problems in income taxation will be found in an earlier section.' It will be recalled that the problems arise from:

1. Use of residence or situs as the basis of the personal and, in some cases, the corporation tax.
2. Different definitions of residence for tax purposes.
3. Different apportionment procedures.

The problem as to number (1) can be and to some extent has been attacked by means of State credits for taxes paid in other States. These can be extended. As to (2) and (3), and probably also as to (1) in large degree, it has been suggested that uniform rules be determined by Federal-State conference under the auspices of a Federal-State Fiscal Authority and that the Federal Government should offer its services as arbitrator in case of disputes and that it go further, seeking to purchase State compliance by favors granted to the States. No precise solution of the intricate jurisdictional problems has been suggested. It would be valueless in any case unless it were preceded by the requisite negotiations. It has been suggested that a consensus as to apportionment, along the lines of the Massachusetts procedure, should not be too difficult to achieve. A satisfactory rule as to residence and domicile should prove attainable. The claims of residence and situs are the most difficult to arbitrate, but some acceptable compromise, such as a 50–50 rule, would be worth a strong effort. It is jurisdictional confusion that most discredits State income taxation, and a vigorous effort toward uniformity, through the democratic procedure here suggested, is perhaps the most imperative of all reforms needed in intergovernmental fiscal relations.

B. Business Taxes

1. INTRODUCTION

Business taxes probably offer the most difficult problem of coordination in the entire overlapping tax system. The confusion in this sector of the tax system is impressive, and the possibility of repressive effects upon the economy is considerable.

2. NATURE OF STATE AND FEDERAL BUSINESS TAXES

It was observed in discussing the net-income tax that this tax is ordinarily applied to both corporations and individuals, a fact which makes the income tax overlap the field of business taxes. The American system of business taxation occurs at all three levels of government and in a great variety of forms and institutions. In addition to the corporate net-income tax, the gross-income tax and sales tax are business taxes, at least in the broadest sense. In some States, particularly in the South, a great variety of special charges are imposed upon business. In 1940, Alabama had over 150 occupation taxes including such businesses as auctioneers, dealers in dice, dentists, junk dealers, and lumber dealers.[3] These taxes are characterized by great arbitrariness. A few of them attempt a rough measure of the volume of business, but most of them are based upon no reasonable principle whatever. State taxes on corporations as such, in addition to net-income taxes, include incorporation fees (incidental to the acquisition of a corporation charter) and taxes imposed upon foreign business as a condition of doing business in the State, corporate-excess taxes (general property tax applied to the value of intangibles held by and represented by the corporation), and capital stock taxes. Unincorporated business is subject to special net income or other special taxes in several States, in addition to many of the occupational taxes.

The capital-stock tax is a business tax applicable to corporations and based on the privilege of engaging in business in a corporate capacity. The methods of measuring the privilege are numerous and sometimes very arbitrary. The Federal Government employed a capital-stock tax during the First World War and the measure was reinaugurated as part of the depression tax program of 1933. With many modifications, it has continued to the present time. The structure of this tax is unique in that it is based on declared value of stock and is tied to an excess-profits tax based on the declared value figure. The theory behind the two taxes is that they will automatically administer each other. But experience has demonstrated that the incidence of the tax is capricious and otherwise unsatisfactory.

State capital-stock taxes are based either on the market value of stock or upon the par value of securities issued or authorized. In case of no-par stock, the tax is often based on the number of shares. The nature of State taxes on corporations is shown in tables 57 and 58.

TABLE 57.—*State general corporation taxes, Jan. 1, 1942*

State	Net income	Capital stock	Corporate excess	Annual fee	Other
Alabama	X	X	X		
Arizona	X			X	
Arkansas	X	X		X	
California	X			X	
Colorado	X	X			
Connecticut	X			X	
Delaware		X			
Florida		X			
Georgia	X	X			
Idaho	X	X			
Illinois		X	X		
Indiana		X			
Iowa	X				
Kansas	X	X	X		
Kentucky	X	X			
Louisiana	X	X			
Maine		X			
Maryland	X	X			
Massachusetts	X		X		

[3] Tax Systems, 9th edition, Commerce Clearing House, Chicago, 1942, p. 7.

TABLE 57.—*State general corporation taxes, Jan. 1, 1942*—Continued

State	Net income	Capital stock	Corporate excess	Annual fee	Other
Michigan		X			
Minnesota	X				
Mississippi	X	X			
Missouri	X	X		X	
Montana	X				
Nebraska		X	X		
Nevada					
New Hampshire				X	
New Jersey		X			
New Mexico	X	X		X	
New York	X	[1] X			
North Carolina	X	X			
North Dakota	X				
Ohio		X			
Oklahoma	X	X			
Oregon	X	X			
Pennsylvania	X	X			[3] X
Rhode Island		[2] X	X		
South Carolina	X	X			
South Dakota	X				
Tennessee	X	X	X		[4] X
Texas		X			
Utah	X				
Vermont	X	X			
Virginia	X	X		X	
Washington		X			
West Virginia		X			
Wisconsin	X				
Wyoming		X			

[1] New York's capital stock tax is a minimum tax subordinate to the corporation net income tax.
[2] Rhode Island's capital stock tax is a minimum tax subordinate to the corporate excess tax.
[3] Corporate borrowing tax.
[4] Gross receipts tax.

Source: Treasury Department, Division of Tax Research, revised to date from Tax Systems.

TABLE 58.—*Types of business activity subject to special State taxation as of Jan. 1, 1942* [1]

State	Motor carriers	Railroads	Sleeping and parlor car companies	Express companies	Telephone and telegraph companies	Electric light and power companies	Gas companies	Other public utilities	Banks	Insurance companies	Other financial institutions	Merchants, etc.[2]	Other specified activities
Alabama	X	X	X	X	X	X		X	X	X	X	X	
Arizona	X	X	X	X	X	X	X	X		X	X	X	X
Arkansas	X				X	X	X	X		X		X	X
California	X	X	X	X	X	X	X	X	X	X	X		X
Colorado	X				X	X	X			X	X	X	X
Connecticut	X	X	X	X	X	X		X		X			
Delaware	X	X		X	X	X	X		X	X	X	X	X
Florida	X	X	X	X	X	X	X		X	X		X	
Georgia	X									X		X	
Idaho	X			X		X			X	X	X		X
Illinois	X	X			X	X	X		X				
Indiana	X	X	X	X	X	X	X	X	X	X	X		
Iowa	X	X	X	X	X	X	X	X		X	X		X
Kansas	X		X	X	X	X	X	X		X	X		
Kentucky	X	X	X	X	X	X	X		X	X	X	X	X
Louisiana	X	X	X	X	X	X	X	X		X		X	X
Maine	X	X	X	X	X				X	X	X		
Maryland	X	X	X	X	X	X	X		X	X		X	X
Massachusetts	X				X	X	X	X	X	X			X
Michigan	X					X	X	X		X	X		X
Minnesota	X	X	X	X	X					X	X	X	X
Mississippi	X	X	X	X	X	X	X	X	X	X	X	X	
Missouri	X	X	X	X	X	X	X	X		X		X	X
Montana	X		X	X	X	X	X			X		X	X

[1] Taxes on public utilities are treated as special if the tax differs from that on other corporations, or from the property tax on other property.
[2] Licenses referring to a single class of business (as merchant's license tax) or to numerous, but not all, classes of business activity.

TABLE 58.—*Types of business activity subject to special State taxation as of Jan. 1, 1942*—Continued

State	Motor carriers	Railroads	Sleeping and parlor car companies	Express companies	Telephone and telegraph companies	Electric light and power companies	Gas companies	Other public utilities	Banks	Insurance companies	Other financial institutions	Merchants, etc.	Other specified activities
Nebraska	X			X					X	X	X		
Nevada	X				X	X	X	X		X			X
New Hampshire	X					X	X		X	X	X		
New Jersey	X	X	X	X	X	X	X	X	X	X	X		X
New Mexico	X	X	X	X	X	X	X	X	X		X	X	
New York	X	X	X	X	X	X	X	X	X	X	X		X
North Carolina	X	X	X		X	X	X	X		X		X	
North Dakota	X	X	X		X	X	X	X	X	X	X		
Ohio	X	X	X	X	X	X	X	X	X	X	X		
Oklahoma	X	X			X	X		X					X
Oregon	X	X	X	X	X	X	X	X		X			
Pennsylvania	X	X	X	X	X	X		X	X	X	X		
Rhode Island	X	X	X	X	X	X	X	X	X	X			
South Carolina	X	X	X	X	X	X		X		X		X	
South Dakota	X			X	X	X	X	X		X			
Tennessee	X	X	X	X	X	X	X	X		X		X	X
Texas	X	X	X	X	X	X	X	X		X		X	X
Utah	X	X	X	X	X	X		X		X		X	
Vermont	X	X		X	X	X							
Virginia	X	X	X	X	X	X	X	X	X	X		X	
Washington	X	X	X	X	X	X	X	X		X			
West Virginia	X	X	X	X	X	X	X	X				X	X
Wisconsin	X	X			X					X			X
Wyoming	X		X	X	X	X	X	X	X	X			X

Source: Treasury Department, Division of Tax Research memorandum, 1939; revised, 1942, from Tax Systems.

3. OBJECTIVES

No program for the coordination of business taxes can proceed far without confronting the question of objectives in this form of taxation. The Federal system of business taxation is itself uncrystallized and is at present ordered considerably by the exigencies of war finance. The absence of a Federal policy renders plans for Federal-State coordination doubly difficult. No generally accepted objectives of sound business taxation are available. The following are suggested for possible application:

1. Even if there is any valid reason for taxing business as such at all, it seems that the relative place of business taxation in our tax system is too large, and that this form of taxation should be "deemphasized."
2. An important present justification for business taxes is that considerable income is short-circuited within corporate business and reaches the stockholder only after considerable delay, if at all. New techniques should be devised for subjecting this short-circuited income to the same scale of personal income taxation as is applied to distributed income.
3. The present combination of heavy taxes on corporate net income, and additional taxes on dividends as part of the base of the stockholder's personal income tax, places an unwarranted differential strain on equity financing. Either bond interest should be disallowed (with appropriate limitations) in the computation of the corporate tax base or, better still, a partial

credit might be given the corporation for dividends paid out. If it be true, as is sometimes argued, that business is regularly subject to a certain amount of "concealed obsolescence"[4] not accounted for in the tax base, the credit might be extended to some arbitrary percentage of undistributed income, say 10 percent.

4. There is considerable support for the view that corporations should pay some taxes, in addition to property taxes, for the benefits received from governments. This would mean the utilization of bases which would reach businesses without, as well as with, net income. However, it seems probable that applying taxes to income after deduction of costs is likely to be less repressive than making taxes a universal business cost. Moreover the incidence of business taxes based on other factors than net income is uncertain and confused.[5] A retail sales tax, aimed at the consumer and close to him in its application, is more likely to achieve its desired effects. A tax system consisting of a personal and corporate income tax and a retail sales tax would be preferable to one consisting of the first two and business taxes based upon gross income, value added, or capital stock. Accordingly, it is recommended that no attempt be made by the Federal Government to extend its business tax system to corporations operating at a loss and the tendency of States and cities to levy such taxes be discouraged.

5. Whether partnerships and individual proprietorships should be included in the scope of a business tax is a difficult question, especially since there is no clearly defined limit for the term "business" and it can easily be stretched to include all productive activity—even that of wage earners. Probably only more confusion would result from an attempt to tax individual businesses and occupations generally.[6]

6. The excess-profits tax, whether or not it is to be used beyond emergency periods, requires Federal perspective for its successful application and need not concern us further here.

7. Whether or not special treatment is required for the taxation of insurance companies, banks, and public utilities is another troublesome problem. Probably an effort should be made to integrate, so far as possible, these special classifications under a general business tax. An exception in the case of insurance is probably warranted so far as the States are concerned, but even here the Federal Government should continue its experimentation with the difficult task of integrating insurance and net income taxation.

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[4] It is alleged that some continuous new investment is necessary to keep a business abreast of the times; this is independent of such allowance for obsolescence as may be realized through the sale or discarding of physical property.

[5] However, it is contended by some critics, with plausibility, that there are grounds for thinking that a substantial part of the corporate net income tax is passed on to the consumer or back to the factors of production. The incidence of this tax, too, is not entirely free from uncertainty.

[6] Some experimentation with special taxes on unincorporated business has occurred in New York and Connecticut. The base of the Connecticut tax is gross income and that of New York, net income. Both States allow a substantial number of special exemptions and New York, in addition, confines its tax to recipients of $5,000 or more net income. About 7,000 firms are subject to tax in New York; the number in Connecticut is about 30,000. These taxes undoubtedly lessen the tax advantage of some firms competing with corporations, but it can hardly be said that these levies are an important development in extending the scope of business taxation or clarifying business tax theory. For sources see: Paul Studenski, "New York State's Experience With a Tax on Unincorporated Business," How Shall Business be Taxed, Tax Policy League, New York, 1937, pp. 86-87; J. J. Rauh, "The New York State Tax on Unincorporated Business," Taxes, vol. 17, No. 6, June 1939, pp. 345–347, 377; Ernest S. Goodrich, "Connecticut's Unincorporated Business and Cigarette Tax," Bulletin of the National Tax Association, vol. 22, No. 6, March 1937, pp. 168–171; State of Connecticut, Report of the Connecticut Temporary Commission to Study the Tax Laws and to Make Recommendations Concerning Their Revision, 1934, pp. 460–469.

4. TECHNIQUES FOR DEALING WITH UNDISTRIBUTED INCOME

Although the above subject is as legitimately discussed under the net income tax as under business taxes, and although the problem is one of integrating corporate and individual income taxes rather than a Federal-State coordination problem, it seems desirable to consider in some detail the techniques for dealing with undistributed income. The problem has an important bearing on the kind of business taxes to be selected and on the place of business taxation in the tax system. It also has a bearing on possible means of relieving equity financing from discriminatory tax burdens.

All methods by which total corporate earnings might be made taxable to their individual owners involve technical difficulties, and there is considerable diversity of opinion as to which is most feasible. Four principal means of reaching the individual interests in corporate savings have been suggested:

1. The inventory method: Appraise the beneficial interests of individual shareholders in the corporation at regular intervals.
2. The partnership method: Tax to the individual shareholders the distributive shares of corporate profits, whether distributed or not.
3. The compulsory distribution method: Force the corporation to distribute all income to the shareholders, thereby rendering such income fully taxable.
4. The compensatory tax method: Disregard the individual and impose a tax on the corporation at a rate calculated to produce for the Treasury approximately the amount of taxes the shareholders would have paid under the personal income tax had the corporate profits been completely and promptly distributed.

Only the first three of these methods aim at the perfection of the personal tax with a high degree of precision. The fourth would obviously approximate the application of ability to pay with extreme roughness. A discussion of the first three methods follows:

(a) *The inventory method.*

The procedure of the inventory method is explained by the Final Report of the National Tax Association Committee on Federal Taxation of Corporations as follows:[7]

The accretion concept of income, carried to its logical extreme, takes into account every factor affecting the increase or diminution in the economic strength of the individual between two points of time. One important factor in the case of the typical taxpayer is the amount of profits made by any business in which he may have an interest. Even if these profits be not physically distributed to the taxpayer, their existence will presumably be reflected in the value of his interest. Consequently, by comparing the values of his interest at the beginning and at the end of his taxable year, it should be possible to secure a figure which fairly represents the improvement of the economic position of the taxpayer so far as his ownership interest in the business is concerned. Undivided profits will have registered their effect, as will also any other significant factor affecting the position and prospects of the business. It follows that, if the value of the beneficial interests of taxpayers in business concerns * * * could be accurately appraised at regular intervals, it would be possible to ignore all the business entities and to deal only with individual interests, which would be regularly inventoried on a market value basis.

[7] Robert Murray Haig, chairman, "Final Report of the Committee of the National Tax Association on Federal Taxation of Corporations," Proceedings of the National Tax Association, 1939, p. 545.

The inventory method values all items at market prices. It thereby not only offers, in theory, a completely satisfactory solution to the problem of applying the personal income tax to the undivided profits of corporations, but it also provides a solution of the general problem of capital gains and losses. Market values of securities presumably reflect among other factors the existence of undivided profits. The inventory method in effect proposes that capital gains be taxed at regular intervals, rather than irregularly at the closing of capital transactions.

The practical application of this method faces the following two difficulties among others: (1) The general lack of dependable periodical valuations of the equities involved, because most interests are not represented by securities dealt in actively on organized exchanges, thus rendering the method unavailable for use in a comprehensive manner. (2) In the light of previous judicial decisions, there is doubt of its availability on legal grounds. The compulsory and comprehensive application of the inventory method might require a constitutional amendment.[8]

(*b*) *The partnership method.*

This plan is briefly summarized by the Haig report.[9]

> * * * The next most attractive approach from the point of view of theory is essentially the device long used in this country in the case of partnerships, namely, individual taxation of the distributive shares of the corporate profits whether distributed or not. In contrast with the inventory method (which deals with the reflection, in the value of the shareholders' equity, of the current earnings of the corporation, as modified by the reflection of any other significant factors that may be present), the partnership method merely attempts to make certain that each year each owner's aliquot share of the corporation's current earnings is fully taken up in the individual personal income tax return. Other factors affecting the value of the stockholder's equity are ignored until the stock is disposed of.

Here again there are great difficulties. The corporate structure is sometimes more complicated than the partnership structure, and the task of assigning the undistributed earnings to the proper parties may be extremely involved. In addition, the legality of the method, applied on a compulsory and comprehensive basis, is not free from doubt.[10]

The partnership method is not employed anywhere on a comprehensive scale. However, it has been used with success to cover a very substantial area of the corporate field in Australia, the private companies.[11]

(*c*) *The compulsory distribution method.*

This method applies pressure on the corporations to compel them to distribute their earnings to their shareholders, in whose hands they will then be subjected to the full impact of the rate scale of the personal income tax.

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[8] Ibid., pp. 516-517. As far as the Haig committee was aware, no country has made comprehensive use of the inventory method as a solution of the corporate savings problem. However, the Twentieth Century Fund Committee recommended it—Facing the Tax Problem, p. 477.

[9] Haig, op. cit., p. 547.

[10] *Eisner* v. *Macomber* (252 U. S. 189 (1920)).

[11] In Australia a private company, that is, a company "which is under the control of not more than seven persons, and which is not a company in which the public are substantially interested," must distribute, within 6 months of the close of its taxable year, the whole of its "distributable income," which equals taxable income minus income taxes and net losses outside Australia. Otherwise, it is subjected to the partnership method of taxation, the tax being payable by the corporation and the amount being "the aggregate additional amount of tax which would have been payable by its shareholders if the company had * * * paid the undistributed amount to the shareholders * * *." Joseph H. Barkmeier, "Income and Excess Profits Taxes in Australia," International Reference Service, U. S. Department of Commerce, Washington, vol. I, No. 41, 1940, p. 7.

The essence of the method is pressure, and the pressure theoretically demanded is of a degree sufficiently great to accomplish its object completely; if the pressure is exerted through a tax, it should be a penalty tax which no corporation would ever pay.[12]

It will be noted that the compulsory-distribution method, as it relates solely to the distribution of the tax burden, need not necessarily mean that the dividends be declared in cash. Such distribution might conceivably be made by one or more of four methods: (*a*) Cash dividends, (*b*) stock dividends payable in a kind of stock different from that already owned by the stockholder, (*c*) stock dividends payable in stock of the same kind as that already held by the stockholder, and (*d*) information certificates advising each stockholder (and the government) of his share of the undistributed earnings.

Compulsory cash dividends may frequently produce hardships and discourage commitments of reasonable duration. The present legal requirement, that stock dividends to be taxable income to the stockholders must be paid in stock of a kind different from that already held by the stockholder, has the serious disadvantage of forcing the issuance of special kinds of preferred stock and thereby seriously complicating corporate structures. If stock dividends payable in stock of the same kind are used, it is questionable whether under existing judicial rulings stockholders would be required to pay taxes on such distributions. However, even if legal, the compulsory issuance of stock of any kind would result in disturbance to corporate financial structures; and it is impossible under some State laws, so long as the corporation has a deficit. In addition, the issuance of stock results in stock taxes and State franchise taxes which are inherently foreign to the income-tax problem. If information certificates of earnings were used, the economic repercussions upon the corporation would be no different from those involved in the use of the partnership method.

The Haig committee concludes regarding the compulsory distribution method:

The administrative difficulties involved in the use of the compulsory distribution method, however, are by no means so serious as those involved in the use of the inventory and partnership methods. Regarded merely from the viewpoint of taxation technique, much can be said in favor of it as a method of solving the problem now under consideration, particularly if stock dividends can be utilized. Its most serious faults, and to some of our members they seem grievous indeed, lie in the field of the economic consequences of compulsory cash distributions.[13]

All the committee members agreed that considerations of equity call for a tax on undistributed profits as heavy as that on distributed profits. However, the members differed in their estimates of the legal and administrative practicability of the alternative proposals, and also on the importance of stimulating or discouraging corporate savings.[14] This was the reason for some of the disagreements in recommendations of policy.

(*d*) *Other proposals.*

The majority of the committee, consisting of those members with whom consideration of equity outweighed the alleged advantages of a subsidy to corporate savings,[15] preferred tax devices which would

[12] Haig, op. cit., p. 549.
[13] Ibid., pp. 550-551.
[14] Ibid., p. 555.
[15] Ibid., p. 556.

affect the actual cash dispositions of corporations as little as possible. It suggested the following devices:

1. Tax corporations whose capital structure is simple and whose stocks are not widely dispersed by the partnership method.[16] If this method is not legally valid, a constitutional amendment should be sought.

2. For all other corporations, the majority preferred a method which would approximate the results of the partnership method. The members of the majority could not agree on a choice, and presented several alternatives.[17]

(a) Use taxable information certificates, thus applying the compulsory distribution method [18] to the nonpartnership group. Even very large corporations of complicated structure can probably supply their shareholders with the necessary data to enable them to include their share of undistributed earnings in their personal tax returns. The advantage of this plan is that the financial structure of the corporations is not disturbed.

(b) Use taxable stock dividends instead of information certificates, but allow each corporation the option of being taxed as a partnership. The proponents of this plan stress the greater convenience to the taxpayer of receiving a salable instrument.

(c) Apply the compensatory tax to corporations which cannot be taxed by the partnership method.

3. In case these methods should not be feasible, the majority recommended a compensatory tax on undistributed profits imposed directly on the corporation. Any rate scale designed to yield a sum that will protect the interest of the Treasury, will, when applied to undistributed profits, usually both work an injustice to the poor shareholder and grant a subsidy to the rich shareholder. This is true even when the compensatory tax is accompanied by rebates available upon distribution. "However, the inequities involved are much less important than the inequities that exist in a situation in which the distribution of corporate savings is not enforced and no compensatory tax is levied." [19]

A minority of the committee took the position that no corporation should be required to use the partnership method, provided its accumulation of undivided profits is not in excess of the "reasonable" needs of business, as determined by some such test as that provided by section 102 of the Internal Revenue Code.[20] Section 102 aims to penalize corporations that accumulate surplus with the purpose of avoiding surtaxes under the personal income tax.

Under the above first four general types of solution discussed by the committee, all corporate savings are taxed either to the individual shareholders, as though distributed, or they are taxed to the corporation at rates designed to produce a total yield equal to the amount which would have been collected had all the savings been in the hands of individuals.

The theory behind all four of these types of solution is that, insofar as possible, corporate savings should not be subsidized, from a tax standpoint, as compared with other savings. The theory underlying no one of them implies the assumption that corporate savings are evil or that the corporation or the stockholders are committing any wrong in failing to distribute profits. The theory is simply that there is no reason for favoring corporate savings as compared with savings effected

[16] "The committee is of the opinion that the number of corporations to which the partnership method can be applied without involving formidable administrative difficulties is far greater than is generally realized and includes all but a few thousand, perhaps, of our larger corporations" (ibid., p. 555).

[17] Ibid., pp. 556-559.

[18] The distribution here referred to is a distribution of tax obligations and not of cash.

[19] Ibid., pp. 558-559.

[20] Ibid., p. 560.

by individuals, and that if distributions are withheld for reasons which may be perfectly sound and proper, the savings which are thus withheld should nevertheless be subject to the same taxes to which such savings would be subject in the hands of an individual or partnership.[21]

On the other hand, the penalizing of "improper" accumulations is based not on what the corporation does, and the implications of this action for total tax yield and for equity, but upon the purpose which motivates its action. This rule is objectionable on two grounds. One, motives in the minds of taxpayers should not be the determining factors in taxation. "Motive is difficult of proof in nearly all cases, and, in addition, it is the type of question which breeds more friction and ill-feeling than almost any question of external fact. The chances for manipulation are manifold." [22] Two, even if it were conceded that business accumulations ought to be encouraged, untaxed undistributed corporate income leaves in a more favorable tax position the savings of corporations for business use, as compared with savings accumulated for the same purpose by unincorporated concerns.

The members of the minority recognized the second criticism. It was evident that the failure to bring all corporate earnings to account for personal income taxation involves favorable treatment for corporate savings. However, they were not disturbed by this fact. They held that "corporations with legitimate capital needs should be permitted to plow them back into the business even though this results in postponing or permanently reducing the personal income taxes of certain shareholders." [23] But if this plan results in too marked a discrimination in favor of the corporate form of organization, a similar set of privileges might be extended to unincorporated business.

5. PROBLEMS OF INTERGOVERNMENTAL RELATIONS IN BUSINESS TAXATION

The problems of intergovernmental relations in the field of business taxation are quite abundant. First of all, the field is characterized by great confusion and arbitrariness, resulting in high compliance costs, inequity in competition, and impediments to the development of business. A quite similar situation in Canada was characterized by the Royal Commission on Dominion-Provincial Relations as follows:[24]

> The present complexity [in business taxation] is beyond belief. The most important item is the corporation income tax, levied by the Dominion and most Provincial Governments. There are, in addition, taxes levied by one or more governments, on various bases such as capital stock, number of business places, gross revenue, physical volume of output, period of operation, mileage of track or wire, mileage operated, note circulation, insurance premiums, investments, volume of deposits * * * They [these taxes] have grown up in a completely unplanned and uncoordinated way, and violate every canon of sound taxation.
>
> * * * As a result [of the uncoordinated system], investments in the same forms of business are taxed at different rates in the same Province; investments in the same kind of business are taxed at different rates in different Provinces; investments in business operating on a national scale are double and triple taxed with no relation to earning power; certain forms of business can be and are singled out for discriminatory taxation; tax-compliance costs are uselessly and unreasonably increased. And again, it should be added, the same amount of revenue could be secured without imposing any of these discriminatory and inequitable burdens.

[21] Ibid., pp. 553-554.
[22] Ibid., p. 555.
[23] Ibid., p. 560.
[24] Report of the Royal Commission on Dominion-Provincial Relations, Book II, p. 113.

The same words could have been used to describe with fair accuracy the prevailing system of business taxation in the United States. In addition to the confusion stressed in the description of the Canadian system, the problem of apportionment is quite acute in the United States. This matter has been discussed at length in the sections on multiple taxation and the net income tax. In the case of corporate stock taxation, the situation is complicated by the fact that the State which issues a corporation charter can, within the law, apparently, tax all the securities of the corporation under a so-called franchise tax. As previously explained, this is a great boon to the State of Delaware. But it creates a situation of great unfairness among States, and one that is rife with possibilities of multiple taxation upon cosmopolitan business.

Recommendations for a more coordinated business tax system should begin, no doubt, with suggestions for improvement of the business tax at the Federal level. Suggestions as to how this might be done have been made above in the outline of desirable objectives of business taxation.

It should be observed at this point that there is considerable support for a more comprehensive program of Federal business taxation. The theory upon which this support is based is that all business receives benefits from government and should pay taxes accordingly. The general property tax as applied to business is one payment by business for benefits received. But the property tax takes no account of business volume, except as the latter correlates with tangible capital.

In accordance with the above approach, it has been suggested [25] for State business taxation that, in the interest of a better balanced program, the use of alternative bases be inaugurated. Net income would remain the major basis for the tax but alternative levies would be provided: One, a flat minimum tax to cover the cost of administration, or to exact a small charge for the privilege of corporate existence; a second, based on gross income ("value added" would be better), to exact a payment on the benefit theory from corporations with no profit, and from cooperatives. It is proposed that rates be so adjusted that normally the average business would pay the net income tax as the highest of the three alternative levies. But even the business without profits would have some taxes to pay, and in time of depression, when the Government is in need of more funds, the gross income tax alternative could be relied upon to insure greater stability of public revenues. The sponsors of this proposal recommended no distinction between incorporated and unincorporated business in the application of this tax. However, some classification, differentiation, and exemption would not be incompatible with the major objectives of the plan.

The proposal just explained is attractive in its symmetry but, as previously suggested, because of the confusion of incidence involved, and the dangerous economic effects (including the aggravation of deflation at the low point of the business cycle) that might ensue, the program is regarded as inadvisable.

A good case could be made for the exclusive taxation of business by the Federal Government with the States sharing in the revenues.

[25] Committee on State and Local Taxation, "Second Report on a Model System of State and Local Taxation," Proceedings of the National Tax Association, 1933, pp. 353-427.

Probably, a new streamlined, uniform, and centralized system should replace our complicated, highly diverse, highly arbitrary system of business taxation with its high cost of compliance, capricious and extraterritorial incidence, and uncertain effects; with its double- and triple-deck application; and its penalties, through unjust apportionment, upon cosmopolitan business.

This might be accomplished by distribution of a portion of the federally collected tax, on condition that States and municipalities retire from the use of capital-stock taxes, gross income taxes, corporate net income taxes, insurance taxes, and other taxes on business. This program would involve many complications, including the separation of business taxes from property taxes, Federal apportionment, and the adaptation of the program to the needs of the States. Against these must be balanced the shortcomings of the existing system—compliance costs resulting from diversities, injustices, and losses of revenue because of jurisdictional confusion, and the repressiveness of many State taxes. A quantitative appraisal of what these causes for action add up to is not possible without research, which would seem inappropriate in an emergency period like the present. The results might support a recommendation for complete federalization of business taxes by the application of a Federal sharing program, although this is by no means certain. Were this recommendation made at present, it would have academic significance only, for public opinion is not prepared for such drastic action. In any event, pending a quantitative appraisal concerning the matters above discussed, the practical coordination program that can now be recommended must be confined to the following:

1. Better integration of the personal and corporate income tax at the Federal level, as explained above.
2. Work toward State use of a system similar to the Federal with resulting possibilities of joint administration, mitigation of multiple taxation, and State supplementation.
3. Research and education in this whole field. Particularly important is a quantitative appraisal of the impediments to interstate business resulting from diverse State business taxation practices.
4. Federal incorporation of companies doing an interstate business. As already suggested, Federal incorporation of interstate corporations would not only strengthen the regulation of such corporations, but it would tend to defeat multiple and extraterritorial taxation in the field.

Once the Federal Government has established a business tax system that is in accord with the best thought on the subject, some rewards might be offered to induce States to bring their practices in line with the Federal system. As in the case of the personal income tax, the objective here sought would be State taxation as a supplement of the Federal taxation. The Federal Government in such a program should gradually, and in conference with the States, assume the function of determining States' jurisdiction to tax. This program is a long-range one, not to be realized in this year or next. It designates the directions in which progress is to be made and in which it is time to start moving.

6. BANKS, INSURANCE COMPANIES AND PUBLIC UTILITIES

Banks are distinguished from other businesses in that much of their property is intangible, and in that some of them are chartered by the Federal Government. All of them operate in a field that has been of direct Federal concern since the adoption of the Federal Constitution. As a result of this unique status, Congress, backed by the Supreme Court, has laid down rules for the taxation of national banks, and these limitations, because of competitive factors, have often been applied to State as well as national banks. The situation has created some degree of uniformity in the application of the State tax system to the banking business. States that tax general intangibles under their property tax system usually apply a "shares tax" to banks, in addition to the real estate tax. States which exempt intangibles, or apply a special low rate to them, apply to banks a net income or franchise tax, again in addition to the real estate tax. The system not only protects national banks from discriminatory taxation, but it also provides a degree of immunity from taxation for the banking business. The immunity often includes a complete exemption of tangible personal property from taxation. The present Federal protection of the banking business has been frequently protested by the States, which have urged that they should be given discretion to tax the banks subject only to the rule that no discrimination among banks be practiced. For the present system, it can be said that it has achieved a degree of uniformity that is probably felicitous for the development of the banking business. But there is no reason at all, except an extraordinary series of historical accidents, why banks should escape taxes on furniture and fixtures, and sometimes even livestock, while other taxpayers pay taxes upon similar assets. It is plausibly argued, also, that banks enjoy and require considerable special protection and regulation by government. As long as other business is subject to a variety of taxes, gross income taxes, capital stock taxes, and so forth, there appears to be no good reason why the States should be so largely confined to net income in the application of the business tax system to banks. It is recommended that Federal restrictions on State taxation of banks be relaxed to allow the States more freedom to tax banks, always subject to the limitation that there be no discrimination among banks.

Insurance companies, like banks, have special characteristics, but, unlike banks, they are not under the protecting wing of the Federal Government. Of principal interest in intergovernmental relations are the reciprocal and retaliatory practices of State laws, the diversities in State taxation, and efforts to alleviate the latter.

Reciprocity or retaliation in life insurance taxation is now authorized in all but six States and the District of Columbia. Connecticut uses reciprocity throughout its insurance tax system and New Jersey uses it for life insurance taxation only. In all other cases, retaliation is the method.[26] Under a retaliatory law, State X imposes on foreign insurance companies its own primary or mandatory tax at fixed rates on legally defined bases, but provides that if State Y imposes a higher tax on X's companies, Y's companies shall be taxed in X according to Y's law. The taxing State is thus assured of a mandatory minimum tax and permits a maximum conditioned upon the burdens imposed

[26] Tax Systems, ninth edition, Commerce Clearing House, Chicago, 1942, pp. 293-297.

by another government and in reprisal for burdens imposed.[27] New Hampshire's law is typical of the pure retaliation measure. In effect, a State increasing taxes on foreign insurance companies also increases the rates applied by others to its companies. Under reciprocal taxation, on the other hand, a State enacts no mandatory taxes of its own on foreign insurers, but subjects such companies to the same special tax laws, fees, rights and privileges as are imposed by the States chartering such companies. This type of provision thus turns on comity or privileges extended, rather than burdens imposed by other jurisdictions.[28] Actually the practical effect of both types of provision is the same.

The courts have held that reciprocal and retaliatory laws are not a delegation of legislative power even though foreign insurance companies are taxed by one State according to the laws of another State. A legislature may make its law dependent upon a contingency, even if it involves the law of another State.[29]

According to one authority, retaliation and reciprocity afforded considerable tax protection to insurance companies in the decade 1928–37, including the depression years of emergency tax levies. Few increases in rates on foreign companies were made and those mostly in the Southwest where there are few companies doing an interstate business and retaliation has no deterrent effect. The practice has been an important influence for rate stability, but retaliation and reciprocity failed to eliminate discrimination, since a number of States have higher rates on foreign companies.[30] Others claim that reciprocal and retaliatory provisions in the tax laws have tended to eliminate discrimination.[31] The practices of reciprocity and retaliation give no consideration to the place of insurance taxes in the State tax system, to whether they should be property or business taxes, or to what proportion of the business tax burden in a given State should be borne by these companies.

As indicated previously, uniformity is also ascribed to retaliation.[32] This uniformity, however, is confined chiefly to the general form of low percentage rates on the premiums tax base now in general use as a matter of expediency. Except for a few high-rate southern States, which have few domestic companies doing an interstate business, percentage rates are fairly uniform and this is undoubtedly due to retaliation. The lack of uniformity, however, appears in the wide variation of definitions of the legal base of taxation and the construction and application of retaliation among the States. Lack of uniformity in legal definition of the premiums base appears in the specification of premiums taxable and allowances for deductions. These diverse bases may be productive of double taxation, permit escape from taxation, and increase the cost of compliance.[33] The premiums base has been variously defined as premiums received from residents; all first premiums on business in a State and all renewal premiums received in or out of a State on lives in a State; all premiums received

[27] K. M. Williamson, "Reciprocity and Retaliation in Insurance Taxation," Proceedings of the National Tax Association, 1938, p. 462.
[28] R. L. Hogg, "Taxation of Life Insurance Companies under State Laws," Taxes, vol. 17, No. 2, February 1939, p. 73.
[29] R. L. Hogg, "Taxation of Life Insurance Companies under State Laws," Taxes, vol. 17, No. 3, March 1939, p. 171.
[30] Williamson, op. cit., p. 465.
[31] William J. Shultz, American Public Finance, New York, 1942, p. 522.
[32] Cf. H. F. Long, "Interstate Reciprocity in Connection with Corporation and Personal Income Taxation," Tax Relations Among Governmental Units, Tax Policy League, New York, 1938, pp. 73-74.
[33] Williamson, op. cit., p. 473.

in a State or remitted to the home office; such gross premiums as are not taxed elsewhere, etc. One writer classified twenty variations in the legal definition of the nature of premiums.[34] There is also great diversity in provision for deductions.

The growth of the practice of retaliation, carried to great detail for regulatory as well as for tax purposes, has probably encouraged retention of the tax function in insurance departments or with commissioners who are presumably most familiar with the voluminous requirements as to admission of companies, etc. Even so, under the complexities of retaliation, insurance departments are not always equipped to do a thorough job of tax administration and virtual self-assessment by companies may result. One of the virtues of a uniform system of insurance taxation would be the possibility for efficient administration along with other business taxes by tax departments.

Insurance company tax laws are sometimes classed as trade barriers[35] and in some instances they may discourage the interstate practice of this business. However, it is doubtful that many of the rates now applied are sufficiently high to constitute barriers of a serious character. Stability of revenues of the taxing State and freezing of low reasonable rates on all insurance companies are the objectives of insurance taxation in practice. Insurance companies themselves are not seeking removal of the barriers.

Whether or not they are barriers to the free flow of trade, there is reason to believe that diverse insurance tax laws are inimical to the development of this business. The National Association of Insurance Commissioners has given some study to uniformity of the base of insurance taxes and has made certain recommendations toward this end. The New York Commission on Interstate Cooperation has frequently advocated State cooperation to obtain greater uniformity and simplicity.[36] Interstate cooperation appears to hold greater promise than reciprocity and retaliation in obtaining such objectives. A uniform State law providing a uniform base and relatively uniform practice as to rate would be highly desirable. Domestic and foreign, stock and mutual companies, and different forms of insurance written, should be treated largely in the same way.

The consensus of opinion supports the view that a separate base of insurance taxation, apart from other business taxes, is necessary, but there is considerable argument as to the best uniform base. Probably it should include allocated gross income from investments as well as premiums from underwriting. Cooperative effort toward uniformity in this field can be highly recommended. Some promotion from a Federal-State agency might help. While the Federal Government's attempt to integrate the tax on insurance companies in its net income tax has been none too successful, further experimentation in this direction would appear better, in this instance, than an attempt to move toward uniformity with State practice.

Public utilities are not ordinarily in active competition with utilities of other States, and insofar as State rate regulation makes allowance for State taxes, differences in taxes from one State to another are not a serious handicap. The interstate utility, subject to Federal rather

[34] Hogg, op. cit., p. 73. A good compilation of various fees and taxes imposed by States on foreign companies is found in: State of New York Insurance Department, Fees and Taxes Charged Insurance Companies, Publishers Printing Co., New York, 1941.
[35] See ch. III.
[36] Williamson, op. cit., pp. 476–478.

than State regulation, presents a somewhat different problem. States sometimes select the tax base with an eye to maximum apportionment to their own jurisdiction.[37] Federal regulation can conceivably make allowances for these relatively heavy taxes, so that the corporation itself may not suffer any injury; but if the taxes are excessive, they may unduly burden the consumers of public utility services and they tend also to foster State efforts to shift the local tax burden to some other part of the economy, as in the case of railroad taxes in the "bridge" States. Consequently, it is important to work toward uniform State public-utility taxes, except where there is some clear special benefit from nonuniformity, and for uniform burdens on public utilities as compared with other businesses. Special excise taxes on utility services are an acceptable means of putting special burdens on public utility consumers if this is the desired end.

C. Death and Gift Taxes [38]

1. Summary of present death taxes and their importance

The outstanding features of Federal and State death taxation as they affect intergovernmental relations are:

1. The States were first in the field, mainly with the inheritance (rather than estate) type of levy; the Federal Government has been taxing estates steadily since 1916 (there were previous Federal emergency levies), and is steadily gaining a more predominant position in the field. The Federal law is characterized by very high exemptions and by very high rates in the top brackets. State laws, as a rule, allow much lower exemptions and the rates are much more moderate.
2. A principal avenue of death-tax avoidance is through gifts made before death. The Federal Government and 12 States have attacked this problem through the enactment of gift taxes. These jurisdictions, and others that do not have gift taxes, cover gifts in contemplation of death, and gifts to take effect at death, under their regular death taxes. A major proposal in the field advocates the integration of gift and death taxes in such a way that the total tax liability will be the same no matter how the transfers by any one donor are divided between gifts and transfers at death.
3. The principal device of coordination between Federal and State death taxes is the Federal credit. This was adopted in 1924, and amended in 1926, to provide that within limits the taxpayer may pay his Federal tax with State tax receipts. The limit is 80 percent of the Federal tax computed according to the 1926 law. The credit has reduced considerably interstate competition in the State death tax field. In the majority of States it has resulted in "minimum estate taxes," that is, special levies to absorb all of the Federal credit. This coordination device, based on a law nearly 20 years old, is badly out of date as to its application and urgently needs revision.
4. Federal and State death taxes are relatively much less productive than similar taxes in Great Britain. This is due con-

[37] See ch. III.
[38] Based mainly upon a monograph prepared for this study: Loren D. Melton, Death and Gift Taxation.

siderably to a weak coordination system; and especially to the high Federal exemptions, supported by the argument that the States are exploiting the low-bracket field.

5. The death tax is one of the more poorly administered of major State taxes.

6. State death-tax revenues are highly concentrated in a relatively few wealthy States.

2. IMPORTANCE OF STATE DEATH TAXES

The yield of State death taxes, considered in relation to total State tax collections, is of minor importance, and has declined in importance in recent years. This is indicated in table 59.

TABLE 59.—*State death-tax collections, 1931–41*

Year	Amount	As percent of total State tax collections (excluding unemployment-compensation taxes)	Year	Amount	As percent of total State tax collections (excluding unemployment-compensation taxes)
	Millions	*Percent*		*Millions*	*Percent*
1931	$187	9.2	1937	$116	3.8
1932	148	8.0	1938	145	4.6
1933	127	7.3	1939	135	4.3
1934	93	4.7	1940	116	3.6
1935	100	4.5	1941	119	3.3
1936	117	4.5			

Sources: Amounts, 1931-40: "Death and gift taxes," from table 35 (pp. 340-43); 1941 figure from Bureau of Census, State Tax Collections: 1941. Percentages, 1931-40: "Amount" column of this table, divided by "Total State taxes," table 35; 1941 percentage figure computed on the basis of data from Bureau of Census, State Tax Collections: 1941.

This tendency is the product of three principal factors: (1) The decline in property values in the early thirties, (2) increased State reliance upon other sources for additional revenues since about 1935, and (3) unusually large amounts of gifts in the middle thirties stimulated by changes in the Federal gift tax.

It is noteworthy that the States have failed to follow the lead of the Federal Government during the past decade with respect to the enactment of substantially heavier death taxes. In 1932, 1934, 1935, and again in 1940 and 1941, Federal death taxes were increased. In 1932, after a lapse of several years, a Federal gift tax was also adopted. The effect of these enactments has been to increase the yield from death and gift taxes from 1.7 percent of total Federal tax collections in 1931, to 9.8 percent in 1936, but the yield declined to 3.2 percent in 1942 and will probably decline further as the effect of the war financing program is reflected in increased revenues from other sources.

3. GEOGRAPHICAL DISTRIBUTION OF STATE DEATH TAXES

A more detailed picture of State death taxes from 1936 to 1940, inclusive, is presented in table 60.

The distribution of State death-tax collections by the major geographical areas shows a remarkable concentration in the Middle Atlantic and New England States. The three States of New York, New Jersey, and Pennsylvania together accounted for 49.4 percent of all State death taxes for the 5 years from 1936 to 1940, inclusive.

The geographical concentration of death-tax collections reflects in large measure the concentration of wealth and to some extent death rates. New York State produced 25 percent of the total, followed by Pennsylvania (16.2 percent), New Jersey (8.3 percent), Massachusetts (6.7 percent), California (6.6 percent), Illinois (4.3 percent), and so on. Of the average annual $126,021,000 reported by all States, $97,569,000 (77.4 percent) was collected by the following nine States: New York, Pennsylvania, New Jersey, Massachusetts, California, Illinois, Michigan, Ohio, and Wisconsin.

At the other end of the scale 30 States each collected less than 1 percent of the total State death-tax yield during this period. Seven States collected between 1 percent and 3 percent of the total, and four States (in the Great Lakes area) came within the 3-to-6-percent classification. Average annual death-tax collections ranged from $31,476,000 in New York to $63,000 in Wyoming. Six States reported annual average receipts of less than $100,000[39] and 27 States reported less than $1,000,000.

The proportion of death taxes to total State tax collections for each State and regional area is also set forth in table 60. For all States, death taxes produced 4.2 percent of total tax revenues during this 5-year period. The areas of greatest concentration likewise enjoyed the highest ratio of death tax to total collections. In Rhode Island this source yielded 9.5 percent of the total, followed by New Jersey (8.8 percent), Pennsylvania (8.5 percent), Connecticut (8.3 percent), Massachusetts (8.0 percent), New York (7.5 percent). Twelve States collected less than 1 percent of their total tax revenues from this source. Only nine States reported more than 5 percent.

The ratio of death taxes to total collections is determined by a combination of several factors. One, of course, is the wealth of the area. Some States use the inheritance or estate tax more effectively than others. This is probably true for Wisconsin, and possibly for some few other States in which the ratio is substantially higher than in surrounding States. Still another factor of importance is the general expenditure and tax policies of the several States. Some States have gone much further than others in extending financial aid to local subdivisions and, as a consequence, collect a higher proportion of combined State and local revenues. In these States one would expect inheritance or estate taxes to comprise a smaller percentage of State revenues. Caution is therefore to be used in accounting for the ratios shown in table 60.

[39] Nevada, which has no death tax, is omitted from these summaries.

TABLE 60.—*Revenue significance of death taxation in State tax systems*

Region and State	Average annual State tax collections, 1936–40		Tax collections for each State as a percent of all State collections, 1936–40		Death taxes as a percent of total tax collections for each State	
	All taxes	Death taxes	All taxes	Death taxes	1936–40	1934–36
	Thousands	*Thousands*	*Percent*	*Percent*	*Percent*	*Percent*
New England	$196,233	$14,607	6.6	11.6	7.4	7.9
Maine	18,443	686	.6	.5	3.7	3.8
New Hampshire	12,165	775	.4	.6	6.4	5.7
Vermont	9,110	307	.3	.2	3.4	3.4
Massachusetts	105,411	8,433	3.5	6.7	8.0	9.7
Rhode Island	12,726	1,212	.4	1.0	9.5	6.3
Connecticut	38,378	3,194	1.3	2.5	8.3	8.9
Middle Atlantic	781,210	62,257	26.1	49.4	8.0	11.2
New York	422,521	31,476	14.3	25.0	7.5	10.3
New Jersey	118,072	10,409	4.0	8.3	8.8	13.1
Pennsylvania	240,617	20,372	8.1	16.2	8.5	12.1
East North Central	634,260	19,652	21.2	15.6	3.1	3.2
Ohio	171,410	4,408	5.7	3.5	2.6	3.5
Indiana	72,254	1,137	2.4	.9	1.6	1.9
Illinois	177,880	5,427	6.0	4.3	3.0	3.9
Michigan	134,751	4,492	4.5	3.6	3.3	2.3
Wisconsin	77,965	4,188	2.6	3.3	5.4	4.2
West North Central	267,574	4,713	9.0	3.7	1.8	2.6
Minnesota	68,580	1,288	2.3	1.0	1.9	2.7
Iowa	61,273	1,156	2.1	.9	1.9	3.0
Missouri	59,714	1,649	2.0	1.3	2.8	3.6
North Dakota	12,039	80	.4	.1	.7	.7
South Dakota	12,690	68	.4	.1	.5	1.2
Nebraska	21,470	[1] 69	.7	[1] .1	[1].3	[1] 1.9
Kansas	31,808	403	1.1	.3	1.3	1.7
South Atlantic	308,800	7,822	10.3	6.2	2.5	2.1
Delaware	9,603	403	.3	.3	4.2	4.6
Maryland	34,648	1,859	1.2	1.5	5.4	4.8
Virginia	42,578	778	1.4	.6	1.8	1.6
West Virginia	42,703	560	1.4	.4	1.3	1.3
North Carolina	67,058	1,707	2.3	1.4	2.6	1.0
South Carolina	28,498	181	1.0	.1	.6	.7
Georgia	39,054	243	1.3	.2	.6	.4
Florida	44,658	2,091	1.5	1.7	4.7	5.8
East South Central	142,938	2,274	4.8	1.8	1.6	1.0
Kentucky	40,937	1,078	1.4	.9	2.6	1.1
Tennessee	37,388	960	1.3	.8	2.6	2.1
Alabama	38,562	172	1.3	.1	.5	.3
Mississippi	26,051	64	.9	.1	.2	.3
West South Central	245,613	2,232	8.2	1.8	.9	.9
Arkansas	27,114	164	.9	.1	.6	.6
Louisiana	57,042	536	1.9	.4	.9	1.3
Oklahoma	54,543	673	1.8	.5	1.2	.7
Texas	106,914	859	3.6	.7	.8	.9
Mountain	105,418	1,983	3.5	1.6	1.9	2.1
Montana	12,276	392	.4	.3	3.2	4.1
Idaho	10,631	69	.4	.1	.7	.5
Wyoming	6,249	63	.3	.1	1.0	1.0
Colorado	29,422	960	1.0	.8	3.3	4.5
New Mexico	13,356	103	.5	.1	.8	1.0
Arizona	15,054	158	.5	.1	1.1	.4
Utah	15,049	238	.5	.2	1.6	1.1
Nevada	3,381	0	.1	0	0	0
Pacific	305,892	10,481	10.3	8.3	3.4	3.2
Washington	50,751	1,444	1.7	1.2	2.9	1.7
Oregon	23,643	673	.8	.5	2.9	2.4
California	231,498	8,364	7.8	6.6	3.6	3.6
Total	2,987,938	126,021	100.0	100.0	4.2	5.1

[1] State's share only; data on local share unavailable.

Source: Tax Institute, Tax Yields, 1940; 1934–36 data taken from unpublished study made by U. S. Treasury Department, Division of Research and Statistics.

4. HETEROGENEITY OF STATE DEATH TAX PRACTICES; ADMINISTRATIVE WEAKNESSES

For those who entertained the hope that the Federal credit might greatly reduce heterogeneity in State death-tax statutes and administrative practices, the experience with this innovation has been disappointing.

As is evident in table 61, nine categories are necessary to classify the States according to the basic outlines of their transfer-tax structure (including absence of any death-transfer tax). Every State (and the District of Columbia, Alaska, and Hawaii) except Nevada has some form of death tax. Thirty-eight States (also the District of Columbia and Hawaii) have designed their death-tax structures to insure full absorption of the credit allowed by the Federal Government. Seven have insured full absorption of the Federal credit by basing their estate taxes entirely on the Federal levy; 31, by use of the differential estate tax device. Thirty-seven States (and the District of Columbia, Alaska, and Hawaii) have inheritance taxes, supplemented (in all but 8 cases, including Alaska) with the so-called differential estate tax designed to absorb fully the Federal credit. Nine States rely on inheritance or independent estate taxes, or combinations thereof, without special provisions to insure full utilization of the Federal credit.

TABLE 61.—*Types of State transfer taxes as of Jan. 1, 1942*

Type of transfer taxes	State
1. Inheritance tax only	Idaho, Illinois, New Mexico, South Dakota, West Virginia, Wyoming, Alaska.
2. Estate tax based on Federal levy	Alabama, Arizona, Arkansas, Florida, Georgia, Mississippi, New York.
3. Inheritance and differential estate tax	Connecticut, Delaware, Indiana, Iowa, Kansas, Kentucky, Maine, Maryland, Massachusetts, Michigan, Missouri, Montana, Nebraska, New Hampshire, New Jersey, Ohio, Pennsylvania, South Carolina, Texas, Vermont, District of Columbia, Hawaii.
4. Inheritance and differential estate tax; also gift tax.	California, Colorado, Louisiana, Minnesota, North Carolina, Tennessee, Virginia, Washington, Wisconsin.
5. Inheritance and independent estate tax; also gift tax.	Oregon.
6. Independent estate tax	North Dakota, Utah.
7. Independent and differential estate tax; also gift tax.	Oklahoma.
8. Inheritance, independent and differential estate tax.	Rhode Island.[1]
9. No transfer tax	Nevada.

[1] Enacted gift tax in 1942.

As compared to other State taxes, death taxes tend to be relatively stable in rates. Tax rates have been increased substantially in three and decreased in four States since 1937. Excepting in Arkansas and Arizona, the rate decreases were minor in character. These two States enacted laws to conform with the Federal credit, repealing more productive statutes. This indicates some willingness on the part of the States to enact death taxes in terms of the Federal estate tax.

An apparent new trend toward reciprocity in treatment of intangibles of nonresidents is observed. Louisiana, North Carolina, Minnesota, Ohio, and Washington have recently moved to allow such reciprocity; on the other hand, Texas repealed a similar provision in its laws.

A recent searching study [40] of State death-tax administration concludes:

> At present is probably true that among major State taxes none is more poorly administered than the death tax, whether judged by principles of organization, by equity of application, or by available quantitative measures.

On the other hand there is also evidence that in some States the death tax is administered quite satisfactorily.[41]

Diversity in the administration of State death taxes is even greater than in other phases of the State death-tax laws. This diversity extends to the State agency responsible, the local agencies involved, and the division of authority between the two. Much of the inefficiency arises from the fact that those units of government principally responsible for enforcement often have little if any financial stake in the results. Inadequate funds and personnel also contribute to the bad results.

Each of the 47 States with death-tax statutes now assigns a central agency at least partial responsibility for the administration of the tax. Thirty-four of these States designate the chief tax body to serve in this capacity; 4, the State comptroller; 3, the attorney general; 3, the State treasurer; 2, a special inheritance-tax commissioner; and 1, the State auditor.[42]

With respect to functions, these agencies may be divided into three categories: (1) Those having merely supervisory authority; (2) those exercising direct control over the tax process; and (3) those sharing control with the courts.

State supervisory authority, under which valuations are made by appraisers appointed by local probate courts, exists in 20 States.[43] The tax is determined by these courts. Some indirect control is exercised by the State through direct negotiations with appraisers and representatives of the estates on questions of valuation and inclusion of property, and sometimes by exercising a granted right to object to valuations and to the tax as locally determined.

Direct control over the tax process, with subordinate authority lodged in probate courts, is to be found in 18 States.[44] Here the State agency receives returns directly from representatives of the estates, audits them, makes appraisals, determines valuations, and assesses taxes.

A form of shared control, divided between State and local agencies, is to be found in nine States.[45] In some of these, probate court action is reviewed or used as a basis of State tax assessment, while in others the findings of the State body are subject to review by the courts before final assessment.

The decentralized, court-dominated system characterizes the populous East North Central States and most of the West North Central, Mountain, and Pacific regions. Centralized State control dominates the South Atlantic and East South Central areas, while in the New

[40] Walter W. Heller and C. Lowell Harriss, "The Administration of State Death Taxes," Iowa Law Review, vol. 26, No. 3, March 1941, p. 673.

[41] James W. Martin, Cost and Efficiency of Tax Administration, a report prepared for this study.

[42] Heller and Harriss, op. cit., p. 631.

[43] California, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, Missouri, Montana, Nebraska, New Mexico, New York, Ohio, Oregon, South Dakota, Utah, Vermont, and Wisconsin.

[44] Alabama, Arizona, Delaware, Florida, Georgia, Kentucky, Maine, Massachusetts, Mississippi, New Jersey, North Carolina, Oklahoma, Rhode Island, South Carolina, Tennessee, Virginia, West Virginia, and Wyoming.

[45] Arkansas, Colorado, Connecticut, Kansas, New Hampshire, North Dakota, Pennsylvania, Texas, and Washington.

England, Middle Atlantic, and West South Central States, less uniformity prevails.

The inheritance tax is "* * * unique, in that it is the only existent tax which is assessed by a court * * *."[46] Approximately three-fifths of the States vest the probate court with administrative authority in greater or lesser degree in the determination of death taxes. Not only is there a large degree of judicial control of the tax, but the administration is also often largely local. Thus, in California, Idaho, South Dakota, and Wisconsin, county treasurers are the official inheritance-tax collectors. In Wisconsin and Montana, so-called public administrators, some appointed and some elected, have the duty of representing, with the aid of the State agency, both the State and the county in inheritance-tax proceedings. These officials are frequently underpaid through an antiquated fee system, and they are paid whether they have adequately performed their allotted tasks or not. Other local officials participate in death-tax administration in other States.

> Self-assessment prevails to a degree never contemplated in the statutes. The fact is recognized by State officials, who, in State after State, privately admit that the attorney representing the estate is "the key figure in the administrative process" and that they must ordinarily rely on his competence and integrity for full disclosure and valuation of property.[47]

Relatively less is known about Federal than about State death-tax administration. The Federal Government has a smaller problem by virtue of the high exemptions prevailing in the Federal Act. In general, it is known, however, that the administration is centralized and in the hands of competent personnel.

5. STATE AND FEDERAL GIFT TAXES

The first State gift-tax laws were enacted in 1933 by Wisconsin and Oregon, following the reenactment in 1932 of the Federal gift tax. By 1942, 12 States had entered this field.[48] The fact that 6 of these States enacted their gift-tax laws within the past 3 years suggests that the development of this tax among the States may be gaining momentum.

As a direct source of State revenue, the gift tax remains of little importance. It is also an unstable source. State gift-tax collections totaled $1,646,000 in 1939 and $771,000 in 1942. The ratio of gift to death-tax collections has been highest in Oregon (13.4 percent), Virginia (12.7 percent), and Wisconsin (9.9 percent). However, these taxes are designed principally to prevent avoidance of State death taxes (inter vivos transfers reduce the volume of transfers at death), and the effect of the former may be reflected in the receipts of the latter. Indirect augmentation of State revenues is incapable of measurement, but it is thought to exceed the direct yield of State gift taxes.[49] States in enacting gift taxes also help somewhat in protecting the Federal estate-tax base. Gifts which split large estates have an adverse effect on net income-tax receipts, and insofar as gift taxes tend to prevent such gifts, income-tax revenues are supported.

46 Wisconsin Tax Commission, Biennial Report, 1938, p. 11 (cited in Heller and Harriss, op. cit., p. 639).

47 Heller and Harriss, op. cit., p. 645.

48 Oregon (1933), Wisconsin (1933), Virginia (1934), Colorado (1937), Minnesota (1937), North Carolina (1937), California (1939), Tennessee (1939), Louisiana (1940), Oklahoma (1941), Washington (1941), Rhode Island (1942).

49 C. Lowell Harriss, Gift Taxation in the United States, American Council on Public Affairs, Washington, 1940, ch. VIII.

In fact, it is alleged that the States are wasting their tax resources and neglecting an opportunity to improve the equity of their tax laws by not enacting gift taxes. The fact that no Federal credit is allowed for State gift taxes paid is a factor in this situation, and Federal extension of its credit so as to encourage the enactment of State gift taxes can be strongly supported. Concurrent integration of gift and death taxes at both levels would greatly strengthen the whole death-tax system.

Similarity of gift and death taxes suggests the feasibility of integration at the State level, but interstate competition will probably deter such action until appropriate steps are taken by the Federal Government to integrate estate and gift taxes and better to coordinate Federal and State taxes in these fields.

Close similarity in the base of the gift tax is observed in the 12 State laws, probably as the result of the Federal pattern, but much variation exists with respect to exemptions, exclusions, bracketing, and rates. The levying of gift-tax rates at three-fourths of estate-tax rates, as provided by Federal law, has not been generally followed by the States. In most States, gift- and death-tax rates are identical. In Oregon, gift-tax rates are higher, while in Minnesota and Washington, they are lower than death-tax rates. State gift taxes are usually levied on the donor, but in Wisconsin it is the donee who is taxed.

6. FACTORS BEARING ON FEDERAL VERSUS STATE USE OF DEATH TAXES [50]

Whether the Federal Government, the States, or both, should use the death-tax field as a source of revenue has been a matter of considerable dispute. Reference has been made in an earlier section to the opposition by the National Tax Association and others to Federal entrance into the death-tax field and their demand for Federal withdrawal in the middle 'twenties. Secretary Mellon supported this view and stated before the Ways and Means Committee of the House of Representatives that "by tradition, legal theory, and revenue necessity the death tax belongs to the States."[51] Some taxes, he said, could be more properly levied by the States than by the Federal Government and the death taxes belong in this class.

The legal-theory argument referred to is based upon the proposition that the States control the transfer of property and have the ultimate title to land and other property. It is under State laws that property at time of death passes from the deceased to the heir, and it is to the State that the property escheats in case there is no heir. These facts may give the States some advantages in the administration of the death tax, but they hardly establish a case for withdrawal from the field by the Federal Government.

A vital consideration in the death-tax field is the propensity of taxpayers to migrate "out from under" a high State death tax. States are sorely tempted to bid for wealthy residents by setting up very lenient death taxes or by entirely eliminating such taxes. Any State hesitant about entering this competition would be pressed to do so in order to avoid loss of its tax resources. Florida, in 1924, adopted a constitutional amendment ruling out all inheritance taxation. This was done with the avowed purpose of attracting the aged wealthy to establish their domiciles in Florida. The strategy included

[50] Adapted from Harold M. Groves, Financing Government, pp. 244-246.
[51] House Committee on Ways and Means, Hearings, Revenue Revision, 1927-28, 69th and 70th Cong., p. 13.

the purpose of taxing the wealth which might be brought within the borders of the State before its owners died rather than after. Nevada, following somewhat the same strategy, repealed its inheritance-tax law in 1925. Without Federal support, State taxation of inheritance is likely to degenerate into competitive underbidding much like that of State incorporation of corporations.

The retention by the Federal Government of its place in the death-tax field is also supported on the ground that this alone can result in a more equitable distribution of death-tax revenues and the benefits therefrom. Were the Federal Government to withdraw from the field, some States, such as New York, might secure large revenues from this source, but others, like North Dakota and Arkansas, would derive but scant benefit from it. The equity of this outcome would be highly questionable. Large fortunes are frequently amassed out of the profits from business whose sales, labor, and raw materials flow in and out over a wide area. Thus a wealthy manufacturer of tobacco who dies domiciled in a particular State has in one sense built his fortune from the contribution of tobacco farmers and consumers all over the country. The situation is aggravated where a wealthy individual who has acquired his fortune in one section of the country establishes a domicile in another shortly before he dies. Through the use of death-tax revenues by the Federal Government for central purposes, or for distribution in aids to the States, a broader benefit can be derived from the tax.

It is also contended by proponents of Federal death taxation that the use of the tax by the States must encounter the confusion and inequities of multiple taxation. The possibilities of multiple taxation in the death-tax field are very great. Although the Supreme Court once set out apparently to eliminate this multiple taxation, it has more recently changed its course.[52]

A further objection to death taxes as a source of State and, even more, of local revenue (a few States distribute part of the tax) is that the revenues are quite unstable, fluctuating as much as 400 percent from one year to the next, depending upon the fortuitous factor of when the wealthy residents die. The Federal Government, because of the advantage of large numbers, enjoys a much steadier revenue from the death-tax source.

These arguments add up to make a very strong case for an exclusive Federal death tax. But the States are in the field, and the proprietary interest in maintaining at least a joint occupancy is keenly felt. Perhaps a well-coordinated tax program, which recognizes and reconciles the interests of both parties, is the best outcome that can be reasonably anticipated. This was the aim of the Federal credit for State taxes paid, adopted in 1924 and extended in 1926. However, the credit as a coordination device has not been entirely successful. It has reduced interstate competition, but it has not resulted in the elimination of excessive diversity, poor administration, dual administration and compliance, and multiple taxation. Moreover, the credit is tied to the Federal law, the rates and exemptions of which have been modified in later editions. Thus the coordination of Federal-State death taxes has strong claim for fresh attention and revision.

[52] See Ch. III.

7. POSSIBLE SOLUTIONS FOR COORDINATION IN THE DEATH-TAX SYSTEM

On the merits of the case, as a matter of academic consideration, preference among the coordination devices probably would go to separation of sources, the Federal Government to levy the tax and distribute a portion in the form of aids. As previously explained, the death tax for many reasons is not a very desirable source of State revenue. But the political possibilities of any solution of this sort are, to say the least, remote. Much can also be said for State sharing, but here again the possibilities are remote. Moreover, solutions of this character are open to the objection that they sap the vitality and independence of the States. This leaves the crediting device which, because of its familiarity and flexibility, represents by far the most promising avenue of approach.

8. THE CREDITING DEVICE

A survey of the circumstances under which the Federal death-tax credit was adopted and the experience with its application was summarized for the Treasury in 1937 as follows:[53]

THE EXISTING FEDERAL-STATE CONFLICT IN DEATH TAXATION

The problem insofar as it concerns Federal-State conflict in the field of death taxation is not new, although, as will be shown below, it emanates in part from the ineffectiveness, and in part from the narrowness of scope of the crediting provision initiated by the Federal Government in 1924 and modified in 1926.

The controversy surrounding Federal and State taxation of property transfers had its origin in 1907, at the time when President Theodore Roosevelt urged a heavy Federal tax on inheritances. His proposal was countered on the part of State officials with the plea that death duties be considered State rather than Federal sources of revenue, among other reasons because some States have relied upon this source of revenue for almost a century. The Federal Government's enactment of the estate tax in 1916, and, more particularly, its failure to repeal that levy after the war, rekindled State opposition to the Federal levy and culminated in two conferences on inheritance and estate taxation held in 1925 under the auspices of the National Tax Association. These conferences resolved that the Federal Government should withdraw from the field of death taxation within 6 years and in the interim should afford the taxpayer a maximum 80-percent credit against Federal tax liability for taxes paid to States. No doubt that resolution was in part instrumental in the reduction of Federal tax rates and in the increase of the scope of the crediting provision incorporated in the Revenue Act, which became law on February 26, 1926.

The crediting device incorporated in the 1924 act and subsequently expanded in 1926, implied a willingness on the part of the Federal Government to share its transfer tax revenue with States, first in a ratio of 3 to 1 and later in the ratio of 1 to 4. On the strength of that implication some of the States have made an attempt to bring their death-tax structures into conformity with that of the Federal Government. The post-1926 activities of the Federal Government, however, have been a steady swing away from that early pattern. In 1932, 1934, and 1935 Federal estate taxes were increased without a corresponding increase in the scope of the crediting provision, with the result that the States' share of total death-tax revenues has been steadily diminishing. While the recent revisions of the Federal estate tax have reduced the specific exemption from $100,000 to $50,000 and later to $40,000, the crediting provision has remained unchanged. In consequence, no estate credit is at present permitted for taxes paid to States on the bulk of the estates—those amounting to less than $100,000. Furthermore, since the recent rate increases were more marked in the upper than in the

[53] Estate and Gift Taxes, unpublished Treasury Department memorandum, 1937, pp. 52–53.

lower brackets of the estate tax rate schedule, the relative share of death taxes subject to State credit steadily diminishes as estates become larger. The result is that the States are deprived of the tax credit at both ends of the scale. Between 1931 and 1936 the percentage of Federal estate-tax liability represented by credits claimed for taxes paid to States declined from 76 to 18.3 percent.

To add to the disturbance, the Federal Government enacted a gift tax in 1932 which is so constructed as to encourage the distribution of estates during the lifetime of the owners and thus reduce correspondingly the amount of the estate subject to Federal and, of course, State death taxes. This is apparent from the fact that between 1931 and 1936, the percentage of total Federal transfer-tax liability, including both the estate and the gift tax, represented by credits claimed for taxes paid to States declined from 76 to 11 percent.

In their efforts to counteract the Federal Government's persistence to expel them from the field of property transfer taxation, States have resorted to the obvious—to the enactment of independent death and gift taxes—adding thereby to Federal-State conflict. That no attempt has previously been made by the Federal Government to rectify the situation is probably due in part to the fact that students of the problem have been inclined to exaggerate the remedial effects of the crediting device and to underestimate the extent of existing conflict. It is generally held by Shultz, Lutz, Walradt, and others that the crediting device has served to bring death taxes in the various States in close conformity with each other and with those levied by the Federal Government, with the result that the total imposition upon any estate is largely limited to the amount computed under Federal rates. It may therefore be well to concern ourselves first with the extent of existing interstate-variations with respect to the taxation of property transfers. An examination of the pertinent data will reveal that the optimistic generalizations of the type referred to are not substantiated by the facts.

(*a*) *Quantitative relations of death-tax factors.*

(*1*) *Federal tax credit as a percentage of Federal tax liability, 1936–39.*—The credit against the Federal estate tax for State death taxes paid, not to exceed 80 percent of the tax due the Federal Government under the 1926 act, had for its object the elimination of interstate competition for wealthy residents and the encouragement of uniformity in State death taxation. Perhaps an underlying purpose in the minds of the State tax officials who urged its adoption was the establishment of death taxation as a productive and dependable source of State revenue, and the pegging of the Federal estate tax at some constant fraction of State collections from the same source (one-fourth, in the instant case) pending ultimate withdrawal by the Federal Government from the field.

But whatever may have been the objectives sought to be attained by means of the 80 percent Federal estate-tax credit, the subsequent march of events has left them far behind, illustrating very effectively the essential dynamism of our Federal and State tax systems.

The Federal estate tax, which was supposed to have been pegged at 25 percent of State revenues from the same source, has since grown over and around the State death tax, much as the limb of a tree gradually encompasses a horseshoe, until in 1940, the Federal estate-tax yield was 284 percent of State death-tax collections. Subsequent Federal enactments in 1932, 1934, and 1935 were responsible for this change.

Under the present method of computing Federal estate-tax liability, a computation is first made of the basic tax, so-called, under the 1926 estate-tax law. Against this tentative tax there is credited to the taxpayer (not to the State) the amount of State inheritance or estate taxes paid up to 80 percent of the 1926 Federal tax liability. To this net Federal liability there is then added the amount of Federal tax due under subsequent enactments.

Under the present statutes and administrative practice, the credits allowed taxpayers do not represent moneys collected by the Federal Government and remitted to the States. The Federal Government has no present interest in the allocation of tax credits among the States. It is up to each State to levy and collect its own death tax. The tax credit, if and when allowed by the Federal Government, is a matter entirely between the Government and the taxpayer. Nevertheless, a classification of the amounts of such estate-tax credits is made, by States, for statistical presentation in the annual Statistics of Income published by the Treasury. This classification is made upon a collection basis, which means that the State in which the estate is filed, is given credit, for statistical purposes, for the State tax credit, irrespective of the number of other States to which a death tax may have been paid and which contributed to the total credit allowed by the Federal Government. The effect of this method of classification is to overstate the volume of tax credits in domiciliary States, and to understate the volume in States where the property has its situs. It is probable that the low percentage of tax credit to State death-tax collections and to Federal liability in some States, as it appears in table 62, may be due, in part, to this method of classifying tax credits by States.[54]

Table 62 shows the average annual estate-tax credit by States during the 4 years 1936–39, as contrasted with the average annual Federal tax liability and with State death-tax collections.

An average annual credit of $53.7 millions was allowed for State taxes paid during this period as compared to a total Federal tax liability of $322.8 millions. The credit is thus seen to be 16.6 percent of Federal tax liability. Recent changes will no doubt further reduce the relative importance of the credit.

One would expect that States in which larger estates yield a high proportion of death taxes would show a somewhat higher ratio of estate-tax credit to Federal liability than the national average. This hypothesis seems to be borne out by the statistics. For example, for Florida the credit was 20.1 percent of Federal tax liability; for North Carolina and Michigan the percentage was 19.6 percent; for New York it was 18.6 percent; for Wisconsin, 17.8 percent; and for Pennsylvania, 17.1 percent.

For New Mexico, on the other hand, the credit was but 3.3 percent of Federal tax liability. Other States in this category are North Dakota, 6 percent; South Dakota, 6.2 percent; Arkansas, 6.3 percent; Kansas, 7.6 percent; West Virginia, 9.5 percent; and Mississippi, 9.7 percent. In these States the pattern of estates and inheritances is such that the Federal credit seldom applies.

[54] Moreover, the Federal liability data are by calendar years (1936–39), whereas State tax collection data represent average annual fiscal year collections from 1936 through 1940.

TABLE 62.—*Significance of 80-percent Federal estate-tax credit in relation to Federal liability and State death-tax collections*

Region and State	Average annual estate-tax credits, by States, 1936-39	Average annual Federal estate-tax liability, 1936-39 [1]	Ratio of credit to Federal tax liability, 1936-39	Ratio of credit, 1936-39, to State death-tax collections, 1936-40	Ratio of credit, 1930-36, to State death-tax collections, 1930-36
	Thousands	*Thousands*	*Percent*	*Percent*	*Percent*
New England	$5,554	$36,458	15.2	38.0	....
Maine	206	1,698	12.1	30.0	60.26
New Hampshire	198	1,358	14.6	25.5	25.55
Vermont	75	579	13.0	24.4	29.36
Massachusetts	2,787	18,295	15.2	33.0	47.25
Rhode Island	841	5,042	16.7	69.6	39.30
Connecticut	1,444	9,486	15.2	45.2	52.10
Middle Atlantic	28,811	159,696	18.0	46.3	....
New York	20,429	109,613	18.6	64.9	63.87
New Jersey	2,579	16,205	15.9	24.8	57.25
Pennsylvania	5,803	33,878	17.1	28.5	33.86
East North Central	9,402	57,904	16.2	47.8	....
Ohio	2,147	14,619	14.1	48.7	40.87
Indiana	297	2,449	12.1	26.1	34.22
Illinois	2,465	17,370	14.2	45.4	45.64
Michigan	3,395	17,300	19.6	75.6	64.49
Wisconsin	1,098	6,166	17.8	26.2	28.78
West North Central	1,684	11,922	14.1	35.7	....
Minnesota	388	2,674	14.5	30.1	43.36
Iowa	104	1,032	10.1	9.0	11.72
Missouri	1,012	6,290	16.1	61.4	39.10
North Dakota	4	67	6.0	5.0	10.53
South Dakota	4	65	6.2	5.9	13.13
Nebraska	116	1,057	11.0	[2] 168.1	39.43
Kansas	56	737	7.6	13.9	17.56
South Atlantic	3,562	21,669	16.1	45.5	....
Delaware	235	1,509	15.6	58.3	45.49
Maryland	594	4,312	13.8	32.0	52.62
Virginia	258	2,199	11.7	33.2	54.37
West Virginia	62	650	9.5	11.1	27.94
North Carolina	702	3,574	19.6	41.1	43.83
South Carolina	49	511	9.6	27.1	25.63
Georgia	188	1,584	11.9	77.4	74.59
Florida	1,474	7,330	20.1	70.5	91.34
East South Central	613	4,827	12.7	27.0	....
Kentucky	260	2,000	13.0	24.1	40.82
Tennessee	201	1,435	14.0	20.9	28.89
Alabama	118	1,043	11.3	68.6	92.42
Mississippi	34	349	9.7	53.1	73.85
West South Central	708	6,316	11.2	31.7	....
Arkansas	11	175	6.3	6.7	17.55
Louisiana	163	1,379	11.8	30.4	33.15
Oklahoma	132	1,282	10.3	19.6	54.31
Texas	402	3,480	11.6	46.8	59.38
Mountain	420	3,385	12.4	21.2	....
Montana	11	147	7.5	2.8	29.22
Idaho	10	92	10.9	14.5	15.03
Wyoming	24	183	13.1	38.1	23.51
Colorado	282	1,913	14.7	29.4	38.73
New Mexico	10	300	3.3	9.7	15.22
Arizona	46	301	15.3	29.1	30.14
Utah	37	316	11.7	15.5	8.50
Nevada	0	133	....	....	....
Pacific	2,944	20,605	14.3	28.1	....
Washington	297	1,989	14.9	20.6	35.26
Oregon	102	838	12.2	15.2	30.73
California	2,545	17,778	14.3	30.4	40.57
Total	53,698	322,782	16.6	42.6	....

[1] Liability as shown in the gross estate tax liability prior to deduction of the 80-percent credit.
[2] State's share only; data on local share unavailable.

Sources: State tax collections used are average annual collections for the 5 years 1936-40, inclusive, computed from data in Tax Yields, 1940. (See table 60, p. 472.) Estate-tax credits and Federal tax liability taken from Statistics of Income for 1935 through 1938. Ratio data for 1930-36 taken from unpublished Treasury memorandum.

(2) *The Federal credit and State tax collections.*—The ratio of the Federal credit to State tax collections is, of course, highest in those States that levy only an estate tax sufficient to absorb the 80 percent credit. The States of Georgia (77.4 percent) and Florida (70.5 percent) are in this category. New York imposed an estate tax of 100 percent of the 1926 Federal tax, and as a consequence the 80 percent credit represents a smaller percentage (64.9 percent) of total collections.

The high percentage noted for Michigan (75.6 percent) probably arises from the imposition of low rates on smaller inheritances, in conjunction with the closing of some very large estates to which the differential estate tax applied. The percentage shown for Nebraska (168.1 percent) is, of course, misleading. It does not include the share of local governments, for which data are unavailable.

The Middle Atlantic States, heavily weighted by New York, show a 46.3 percent ratio of credit to State death-tax collections; for the New England States the ratio is 38.0 percent; for the East North Central group it is 47.8 percent; while for the South Atlantic area (heavily weighted by Florida) the percentage is 45.5.

Those areas, on the other hand, in which fewer large estates occur, and in which heavier taxes have been laid upon estates and inheritances in the lower brackets, derive most of their death taxes by virtue of their own independent statutes rather than by operation of the 80-percent Federal credit. The Mountain States' ratio of credit to total death taxes was 21.2 percent; for the three Pacific States the percentage was 28.1; for the four-State West-South-Central group it was 31.7; and for the East-South-Central States it was 27.0. (The fact that Federal credits are reported on a domiciliary basis also has a bearing on those data.)

A State-by-State comparison discloses a percentage range of from 2.8 for Montana to 77.4 for Georgia, with 33 States having a percentage below the average of 42.6 and 13 States having a ratio of credit to total death taxes above 42.6. (Nevada levies no death tax whatever, and the Nebraska data are invalid.)

The necessity for additional revenue (and possibly other factors) has caused the 47 death-tax States to levy taxes (including the differential to absorb the 80 percent credit) amounting to $126 millions annually on the average from 1936 through 1940, i. e., $72 millions, or 134 percent, more than the average annual Federal credit from 1936 through 1939.

(3) *Relation of State tax to Federal tax.*—Table 63 shows the ratio of State death taxes to Federal liability. It discloses a high degree of diversity in State death-tax laws and size distribution of estates and demonstrates the impossibility of settling upon any single crediting provision which will produce substantially the same revenues now being received by the States.

For all States, death-tax collections were 39 percent of Federal tax liability. Generally speaking, the regions of least concentration of wealth (East South Central, Mountain, West North Central) collect more State tax in proportion to Federal liability, while the areas of greatest wealth concentration show an opposite tendency. Uniformity, however, seems to be lacking even within the same areas. In New York, for instance, a Federal credit of 28.7 percent (of 1936–39 liability) would have yielded the same revenue as that actually collected, but a credit of 60.1 percent would have been required for Pennsylvania and a credit of 64.2 percent for New Jersey. On the other hand, in the Mountain States a range is shown of from 34.3 percent in New Mexico to 266.7 percent in Montana. (Again the validity of the data is subject to some question because of domiciliary reporting.)

All of the Federal tax liability for those years would not have sufficed to compensate for State death-tax collections in Iowa (112.0 percent), North Dakota (119.4 percent), South Dakota (104.6 percent), and Montana (266.7 percent). As long as this condition prevails (i. e., higher State than Federal revenues), the possibility of complete coordination of Federal and State death taxes through the instrumentality of the crediting device does not exist. However, the figures make no allowance for the fact that Federal reporting follows the domicile of deceased estate owners. Moreover, the really formidable schedule of rates embodied in the 1941 Federal Revenue Act so dwarfs State tax levies that the effective employment of the crediting device becomes feasible for the first time in many years, as will be brought out hereafter.

TABLE 63.—*Ratio of State death-tax collections to Federal estate-tax liability*

Region and State	Average annual Federal estate-tax liability, 1936-39 [1]	Average annual State death-tax collections, 1936-40	Percent of State collections to Federal liability
	Thousands	*Thousands*	
New England	$36,478	$14,607	40.1
Maine	1,698	686	40.4
New Hampshire	1,358	775	57.1
Vermont	579	367	53.0
Massachusetts	18,295	8,433	46.1
Rhode Island	5,042	1,212	24.0
Connecticut	9,486	3,194	33.7
Middle Atlantic	159,696	62,257	39.0
New York	109,613	31,476	28.7
New Jersey	16,205	10,409	64.2
Pennsylvania	33,878	20,372	60.1
East North Central	57,904	19,652	33.9
Ohio	14,619	4,408	30.2
Indiana	2,449	1,137	46.4
Illinois	17,370	5,427	31.2
Michigan	17,300	4,492	26.0
Wisconsin	6,166	4,188	67.9
West North Central	11,922	4,713	39.5
Minnesota	2,674	1,288	48.2
Iowa	1,032	1,156	112.0
Missouri	6,290	1,649	26.2
North Dakota	67	80	119.4
South Dakota	65	68	104.6
Nebraska	1,057	[2] 69	6.5
Kansas	737	403	54.7
South Atlantic	21,669	7,822	36.1
Delaware	1,509	403	26.7
Maryland	4,312	1,859	43.1
Virginia	2,159	778	35.4
West Virginia	650	560	86.2
South Atlantic—Con.			
North Carolina	$3,574	$1,707	47.8
South Carolina	511	181	35.4
Georgia	1,584	243	15.3
Florida	7,330	2,091	28.5
East South Central	4,827	2,274	47.1
Kentucky	2,000	1,078	53.9
Tennessee	1,435	960	66.9
Alabama	1,043	172	16.5
Mississippi	349	64	18.3
West South Central	6,316	2,232	35.3
Arkansas	175	164	93.7
Louisiana	1,379	536	38.9
Oklahoma	1,282	673	52.5
Texas	3,480	859	24.7
Mountain	3,385	1,983	58.6
Montana	147	392	266.7
Idaho	92	69	75.0
Wyoming	183	63	34.4
Colorado	1,913	960	50.2
New Mexico	300	103	34.3
Arizona	301	158	52.5
Utah	316	238	75.3
Nevada	133		
Pacific	20,695	10,481	50.9
Washington	1,989	1,444	72.6
Oregon	838	673	80.3
California	17,778	8,364	47.0
Total	322,782	126,021	39.0

[1] Liability as shown is the gross estate-tax liability prior to deduction of the 80-percent credit.
[2] State's share only; data on local share unavailable.

Sources: Federal tax liability from table 62 (p. 481). State tax collections from table 60 (p. 472).

(*b*) *Extension of estate-tax credit to smaller estates.*

As previously stated the 80 percent Federal estate-tax credit has been charged with inadequacy because of its failure to cover estates of less than $100,000. It is appropriate at this point to consider the extension of the crediting device to the lower estate brackets.

Dr. James W. Martin, speaking before the National Tax Association in 1935,[55] directed attention to certain criticisms of the crediting device, as it has developed since 1926:

> It is apparent * * * that the crediting device offers one type of solution for the death-tax problem. Moreover, the practice of imposing two separate levies, initiated in the Federal Revenue Act of 1932, has in it much that is constructive. However, the results obtained under the 1926 act, as modified by the Federal legislation of 1932, are in some respects grotesque, because there is failure to work out a studied articulation of the two levies. It is accidental, from the viewpoint of the crediting device, that the 1926 act provides for very mild graduation and, since the credit applies only against the levy imposed in the act, encourages the States to utilize gently graduated estate and inheritance tax rates. Moreover, the two acts together operate to allocate to the Federal Government a very large share of small estates (100 percent in the case of estates of $50,000 to $100,000) and a very small share of large estates. Obviously the economic facts justify a precisely opposite treatment.

As to the first point—the encouragement of mild graduation in State tax rates—a comparison of State tax brackets and rates will disclose that this is probably true with respect to rates upon larger estates, although widely divergent rates still exist. Competition among States, generally speaking, has operated to restrain high State taxes upon the larger accumulations of wealth; the States have stood to gain more from 80 percent of the higher Federal collections than their own independent tax statutes could well produce and, as a consequence, they have in many instances been eager to avail themselves of the Federal credit.

But it is equally apparent that the States have not been prevented from departing from the Federal exemption of $100,000 and from the 1926 Federal rate schedule with respect to the lower brackets, as a glance at the statutes discloses. An examination of the column in table 62 showing the ratio of Federal credit to State death-tax collections discloses a relatively low percentage of credits to collections in the Southern and Mountain States, where an estate above $1,000,000 is something of a rarity.

Nor has the Federal Government been prevented by its death-tax relationship with the States (tentatively established by the 80-percent Federal credit in 1926) from reducing its exemptions below $100,000 in subsequent acts; or from increasing its rates upon smaller estates, as shown by the following comparison of rates on estates of specified size:

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[55] James W. Martin, "Federal and State Relations in Taxation," Proceedings of the National Tax Association, 1935, p. 310.

TABLE 64.—*Percentage increase in Federal estate-tax rates since 1926 on net taxable estates of specified sizes*

Net estate (after specific exemptions)[1]	Tax liability[2]		Percentage of tax to net estate (after specific exemptions)[1]		Percentage tax increase, 1926–41
	1926 act	1941 act	1926	1941	
$10,000	$100	$500	1.0	5.0	400.0
$25,000	250	2,300	1.0	9.2	820.0
$50,000	500	7,000	1.0	14.0	1,300.0
$100,000	1,500	20,700	1.5	20.7	1,280.0
$250,000	6,500	65,700	2.6	26.3	911.0
$500,000	17,500	145,700	3.5	29.1	732.6
$1,000,000	48,500	325,700	4.9	32.6	571.5
$5,000,000	503,500	2,468,200	10.7	49.4	390.2
$10,000,000	1,353,500	6,088,200	13.5	60.9	349.8
$50,000,000	9,353,500	39,888,200	18.7	73.8	294.4

[1] Specific exemption was $100,000 under the 1926 act, $40,000 under the 1941 act.
[2] Computed on a gross basis, i. e., to include amounts which may be absorbed by the 80-percent Federal credit for State death taxes paid.

It will be observed that the greatest percentage increase in Federal tax, 1941 over 1926, occurs in estates ranging from $50,000 to $100,000 net of specific exemption. The depth to which State and Federal Governments will henceforth plow this field of small estates may be anticipated by comparing with the 1941 Federal estate tax the effective tax rates levied by certain States which employ progressive rates in the lower brackets.

In a previous Treasury study, a questionnaire was sent to State tax administrators, and comparative State death-tax data were obtained on estates of specified size, as of January 1, 1937. As a result of this questionnaire, the effective rate of tax on estates of $50,000 and $100,000, respectively (before specific exemptions and under certain assumed conditions), was determined to be the following percentages in certain selected States: Arkansas, 1.18 and 2.10 percent; Montana, 1.90 and 2.65 percent; North Carolina, 1.46 and 1.93 percent; North Dakota, 0.80 and 2.28 percent; Utah, 3.40 and 4.95 percent; Wisconsin, 1.98 and 2.69 percent. In contrast to these effective State tax rates, the 1941 Federal estate tax provides an effective rate on a $50,000 estate (the first $40,000 of which is exempted) of 1 percent, and an effective rate on a $100,000 estate (minus $40,000 exemption), of 9.5 percent. The above State tax rates are thus seen to run somewhat higher than the Federal levy on net estates (before specific exemptions) of $50,000, while the Federal levy on a $100,000 net estate averages from three to four times those of the selected States.

The combined effective State and Federal death tax on estates of $50,000 and $100,000 (before allowance of specific or personal exemptions) is given in table 65.

TABLE 65.—*Combined State and Federal tax as percentage of net estates of $50,000 and $100,000 before specific exemptions*

State	Estate of $50,000 (before specific exemptions)	Estate of $100,000 (before specific exemptions)	State	Estate of $50,000 (before specific exemptions)	Estate of $100,000 (before specific exemptions)
	Percent	*Percent*		*Percent*	*Percent*
Arkansas	2.18	11.60	Oklahoma	1.90	11.70
Kentucky	2.53	12.13	Oregon	2.85	12.38
Montana	2.90	12.15	Utah	4.40	14.45
North Carolina	2.46	11.43	West Virginia	3.51	12.92
North Dakota	1.80	11.78	Wisconsin	2.98	12.19

Source: State tax computed on the basis of data from Estate and Gift Taxes, unpublished Treasury Department memorandum, 1937; Federal tax computed at 1941 rates with specific exemption of $40,000.

It is obvious that the much heavier Federal burden imposed upon small estates under the 1941 Revenue Act will accentuate very sharply Federal-State competition at these levels. This conflict will be especially serious for those States that look to the smaller estates for the bulk of their revenue from this source, and especially for those States that permit the deduction of Federal estate tax paid in the computation of net taxable estate for State purposes. Repeal of this deduction may reasonably be expected to follow this serious Federal incursion into the small-estate area, as these States seek ways and means of protecting their revenues from Federal encroachment.

Attention should also be given, in passing, to the possibility of a relatively heavier incidence of a combined State and Federal death tax in the lower brackets, where the estate receives no benefit from the crediting device, as distinguished from the position of the larger estates which do benefit from the 80-percent estate-tax credit. The present operation of the credit introduces a regressive factor in the death-tax field.

In the same connection, cognizance also is taken of the point mentioned by Dr. Martin, above quoted, that the present estate-tax credit operates to allocate to the Federal Government a very large share of relatively small estates and a relatively small share of large estates, whereas the economic facts justify a precisely opposite treatment. (The large estates are more migratory than the smaller ones and are probably more often the product of factors which operate in a national market.) Since 1935, when this observation was made, the Federal tax burden on estates of less than $100,000 has been substantially increased so that this argument has greater force today than it did in 1935.

The conclusion is reached, therefore, that the increasingly heavy taxation of smaller estates, as provided in the 1941 Revenue Act, should be accompanied by an application of the crediting device to such estates. Indeed, this is a prerequisite to the effective coordination of Federal and State death taxes.

(*c*) *Equivalent of 80 percent Federal credit under 1941 estate-tax rates.*

Let us first determine the equivalent of the present 80-percent estate-tax credit in terms of the 1941 estate-tax law, after which various hypothetical crediting provisions may be considered from the point of view of their adequacy to cover present State death-tax collections and to achieve coordination in this field.

The most recent period for which the necessary statistical analysis of estates is available is for the calendar year 1939.[56] An application of 1941 estate-tax rates to this base involves some rearrangement of brackets and arbitrary shifting of taxable estate from one bracket to another; but a close approximation of the equivalent of the 80-percent Federal credit is obtainable despite these handicaps.

The aggregate of all net estates for 1939 was $2,029 millions, before specific exemptions were allowed. The next taxable base, after deduction of specific exemptions of $504 millions, totaled $1,525 millions. The 1941 tentative tax rates, applied against this base, yield a gross tax of $487 millions. Deducting the 80-percent estate-tax credit allowed for State taxes paid, there remains a net Federal liability under the 1941 estate-tax law of $434 millions, or approximately 60 percent more than the $276-million Federal liability under the 1935 rate schedule, which was in effect during 1939.

A credit of approximately 11 percent of 1941 Federal gross tax liability computed against this 1939 tax base would have equaled the 80-percent credit of $53 millions actually allowed for that year.

It will shed further light upon this matter to show the equivalent percentage credits under 1941 rates for estates of selected sizes. This is indicated in table 66.

TABLE 66.—*Maximum Federal credit (allowed under 1926 act for State death taxes paid) as percentage of Federal tax, at 1941 rates and exemptions, for estates of selected sizes*

Net estate before specific exemption [1]	Total Federal tax at 1941 rates and exemption	Maximum Federal credit for State tax paid	Credit as percent of total Federal tax [2]
$60,000	$1,600		
$80,000	4,800		
$100,000	9,500		
$120,000	15,100	$160	1.1
$150,000	23,700	400	1.7
$200,000	38,700	1,200	3.1
$400,000	100,900	6,800	6.7
$600,000	166,700	14,000	8.4
$1,000,000	310,900	33,200	10.7
$4,000,000	1,814,600	280,400	15.5
$10,000,000	6,057,800	1,067,600	17.6

[1] No excluded life insurance.
[2] The figures in this column are the percentage credit under 1941 rates equivalent in effect to the 80 percent credit under 1926 rates.

The arithmetic average equivalent for estates of all sizes, computed on the 1939 tax base, was about 11 percent. It will be seen that a lower-than-average Federal credit in terms of 1941 liability would suffice as to estates up to a point somewhat above the $1,000,000 level. A credit of approximately 11 percent on a net estate of $1,000,000 would equal the 80 percent credit now allowed on the basis of the 1926 rates and exemptions.

It is apparent that the bulk of the "traffic" falls in the lower estate brackets. The average (arithmetic mean) size of net taxable estates reported during 1939 was $121,120.

[56] Treasury Department, Statistics of Income for 1938, pt. 1, table 2.

(*d*) *At what percentage of Federal tax liability should the credit be set?*

As heretofore suggested, however, the crux of the problem is to determine how the individual States would fare under a greatly lowered credit based upon 1941 Federal tax liability.

For the crediting device to become really effective in accomplishing a high degree of uniformity of burden, a percentage credit must be found which will not merely replace the present 80 percent credit; it must be such a percentage of current Federal liability as will yield to the great majority of States somewhat more than their present and prospective death-tax revenues. This involves a comparison of effective death-tax rates in each State on estates of various sizes from the lowest to the highest. Against these effective State tax rates there can be contrasted the corresponding effective rates represented by percentage credits of 1941 Federal tax liability computed at various levels and upon various hypotheses. On this basis a crediting formula can be devised which may achieve the desired result.

Studies prepared by the Treasury have clearly established the point that, despite the operation of the 80 percent Federal estate-tax credit, and contrary to general belief, great interstate variation in death-tax burden still exists.[57]

Certain broad conclusions may be reached with respect to variations in State death-tax burdens and the ineffectiveness of the present crediting device. The crediting provision has fallen far short of the goal of equalization of the death-tax burdens imposed by the various States. States have not confined their taxes to 80 percent of the Federal schedule of 1926. Instead, they have imposed taxes more than twice as high on the average. Under the death-tax rates and exemptions which States find necessary to meet their needs, the existing credit provision is not broad enough in scope to effect the desired substantial degree of interstate uniformity and equity. In view, therefore, of the variation which permeates all aspects of State taxes on property transfer at death, and in view of the magnitude of such taxes as compared with the magnitude of Federal credit, it is clear that the existing credit provision is in itself inadequate to eliminate interstate competition and Federal-State conflict in death taxation. However, before rejecting the crediting device in favor of outright centralization in the Federal Government, with State sharing of Federal collections contingent upon complete State withdrawal from the field (whether optional or not), or some other plan of coordination, it would appear desirable to investigate the possibility of changing the percentage credit and relating it to current Federal death-tax revenues in such a way as to make it effective. After all, it must be remembered that most unusual changes have occurred in Federal and State finances since 1926, so that it is not surprising that a Federal-State relationship created in 1926 and left unchanged since then should have become outmoded and ineffectual.

Assuming the possibility of discovering a percentage credit of current Federal estate taxes which would accomplish the purpose intended in 1926, there would seem to be several advantages in further employment of the crediting device as against more coercive methods. The States are with few exceptions committed to the crediting device, are familiar with it, have had experience with it, and are not afraid

[57] Estate and Gift Taxes, unpublished Treasury Department memorandum, 1937.

of it. The States obviously do not now associate the allowance of a Federal credit for death taxes with coercion or infringement of State sovereignty by the Federal Government. It is likewise probable that a transition from one credit arrangement to another could be brought about much more readily than could a transition from the existing crediting provision to some system of centralized collection and State sharing. As quickly as it became apparent to each State that it would gain from the new arrangement, statutory implementation would probably be forthcoming in most cases.

It is even possible that general acceptance of a crediting arrangement which would give to each State as much or more revenue than presently flows from its independent death tax statutes might, in due course, bring about repeal of such statutes and complete reliance upon a simple enactment designed to absorb the Federal credit. Dual administration would become unnecessary and Federal or joint administration could be substituted. The differing structures of Federal and State death-tax laws would become less marked if the Federal law were amended to bring exemptions and rates more nearly into line with corresponding State provisions. The objection raised against the crediting device, to wit, that it fails to eliminate the cost of dual administration and of dual compliance, might consequently not be entirely valid. The feasibility of this plan rests upon the development of a crediting formula which will adequately cover the individual position of each State.

An analysis of five hypothetical crediting plans tested for adequacy reveals that the plan which most nearly tends to accomplish the desired purpose is one which allows a credit for State taxes paid of 50 percent of Federal tax liability on the amount of the net estate not exceeding $100,000 and 25 percent on the amount exceeding $100,000,[58] accompanied by a reduction in specific exemption and insurance exemption to a maximum of $20,000 each. Under such a crediting arrangement, the evidence indicates that only the States of North Dakota, Oregon, and Utah might find a tax based on the Federal credit inadequate as a substitute for their current levies. Even North Dakota and Oregon would seem to gain at the lower levels, where most of their estates are likely to be. The rates levied in those States are so far out of line with these of other States that to increase the Federal credit sufficiently to cover them would present all other States with an unnecessarily large increase in death taxes and would result in too great a loss in Federal revenue. But even these States, together with the others, might find it expedient to conform to the proposed Federal credit as the structure of the Federal law is brought more nearly in line with the structure of present State laws, particularly as to the lower estate brackets. As the possibilities of eliminating dual administrative and compliance costs, of establishing uniformity of burden, of stabilizing Federal-State death taxes on a permanent basis, and of achieving other advantages, became more evident to all concerned, added impetus would be given to the movement toward conformity. As previously suggested, the data which must be used as a basis for calculation are so crude that a considerable margin of error must be anticipated.

[58] I. e., 50 percent of the Federal tax on the first $80,000 after deduction of $20,000 exemption, and 25 percent of the Federal tax on amounts above $80,000 after deduction of the $20,000 exemption.

Rough, tentative estimates of revenue indicate an increase in State death taxes under the plan proposed of from 20 to 25 percent (the amount varying from year to year and State to State), with only a small loss in Federal-State-tax revenues. This loss can in all probability be compensated by the application of the Federal tax to smaller estates, integration of the gift and estate tax, and other amendments designed to improve the effectiveness of the law.

Table 67 presents a comparison of the effective rates in certain States with the equivalent rates under the proposed 50–25 percent Federal credit.

TABLE 67.—*Effective death tax rates (1937) in selected States, compared with a modified Federal credit for taxes paid to States* [1]

State	Net estate before specific exemption							
	$50,000	$100,000	$200,000	$500,000	$1,000,000	$5,000,000	$10,000,000	$50,000,000
	Percent	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*	*Percent*
Kentucky	1.53	2.63	5.17	6.30	7.90	11.80	13.51	15.48
Montana	1.90	2.65	4.72	6.11	8.01	10.56	10.88	14.92
North Dakota	.80	2.28	5.93	7.77	11.05	20.25	21.63	22.73
New York	.25	.55	1.42	2.29	3.88	9.68	13.27	18.65
Oregon	1.85	2.88	5.84	7.51	10.75	17.55	18.53	19.31
Pennsylvania	3.22	3.23	3.24	3.24	3.24	7.74	10.62	14.92
Utah	3.40	4.95	8.15	8.89	9.45	9.89	9.94	9.99
West Virginia	2.51	3.42	3.92	4.38	5.41	9.09	10.82	13.09
Wisconsin	1.98	2.69	4.73	5.12	8.01	11.56	10.62	14.92
Modified Federal credit	3.00	7.55	7.53	7.72	8.34	12.35	15.22	18.44

[1] Assuming reduction of Federal estate tax exemption to $20,000 and modification of Federal credit to allow a 50-percent credit for taxes paid to States on the amount of the estate not exceeding $100,000 (i. e., on the taxable amount not exceeding $80,000) and a 25-percent credit for taxes paid on the amount of the estate exceeding $100,000 (i. e., on the taxable amount exceeding $80,000).

It is desirable that, with each future amendment to the Federal estate tax, the Federal credit be restated in terms of the law as amended. In other words, the credit allowed for State taxes paid should at all times represent a proportion of *current* Federal tax liabilities. The argument that such increase might be unrelated to State needs seems to be of little force when set against the more important advantages to be derived from a coordinated scheme of death taxation. It is recommended that the percentage of Federal tax liability heretofore suggested, once enacted, be continued until such time as conditions clearly demonstrated the need for a change.

(*e*) *Use of the credit to solve problems of dual administration and jurisdiction.*

One of the advantages of a plan of coordination resulting in a single death-tax administration by the Federal Government or a single joint administration, which an adequate credit would tend to bring about, is that it could do much to solve the problems of double domicile, and multiple taxation of intangibles. In order to accomplish this, it would be necessary to amend the Federal estate-tax law to provide for Federal determination of domicile and geographical distribution by States of estates the property of which is located in more than one State. Acceptance of this provision might be required of the States as a condition precedent to the receipt of the Federal credit; or the provision might be offered in a somewhat more palatable form as an option for those States that desire to avail themselves of the administrative services of the Federal Government. It is not believed that such ministerial provisions, which are designed to provide a fair allocation of the tax base among the States and reduce litigation growing out of conflicting State interests, would constitute a serious infringement of State sovereignty. The mild degree of coercion involved would be offset by the many advantages of the arrangement.

The rules of jurisdiction which have become quite well established and generally accepted are the following:

1. Transfers of real estate are taxable by the State in which property is located.
2. Tangible personal property is taxable where situated or customarily kept at the time of the owner's death.
3. Intangible personalty is taxable by the State of domicile, and, under recent decision, is also taxable by other States which "extend the protection of their laws" to such property. Moreover, more than one State may claim the domicile of the decedent (as in the Dorrance case). Two or more States may therefore collect taxes on the transfer of the same intangibles.

It has recently been held that both the State of domicile and the State where a trust is administered can lay a death tax on transfer of the same intangibles (*Curry* v. *McCanless*, 307 U. S. 357, and *Graves* v. *Elliott*, 307 U. S. 383), since the decedent has availed himself of the protection of both States' laws. It has also been held that a State can tax the securities of a nonresident decedent if it has incorporated the company issuing the securities.[59]

In view of these conflicting, and often irreconcilable, claims for multiple taxation of the same property, it would indeed be a happy and useful solution were the problem to be resolved by coordination of Federal-State death-tax administration in such a way that a few simple jurisdictional rules prescribed by Congress or the Federal tax administration could fix the share each State is to receive, thus avoiding not only the inequities of double taxation, but much needless and costly litigation as well.

The needlessness of maintaining dual death-tax administration under the arrangements recommended will, it is submitted, become evident. Expensive State administrative departments could be much reduced or abolished; or better still, State and Federal administrative resources might be pooled under a joint administrative program. Some divergence as to rates and exemptions may occur (and may not be undesirable), but a strong impulse toward uniformity and administrative cooperation will have been initiated.

It is contemplated that, to facilitate the work of the Bureau of Internal Revenue and simplify administrative problems incident to the transition from one credit to another, the present 80 percent credit of 1926 Federal tax liability should be repealed simultaneously with enactment of the new credit based on current liability. Payment of independent State death taxes would be allowed as a credit against Federal tax liability up to the amount of the new credit, and it would no longer be necessary to compute the 1926 basic tax. Inasmuch as independent State death taxes are substantially less

[59] *State Tax Commissioner of Utah* v. *Harkness* (10 U. S. Law Week, 4341-4347, April 28, 1942). For further discussion of this case, see pp. 236-38.

than the proposed Federal credit, a substantial inducement would still remain for the States to rely solely upon a minimum estate tax.

In the majority of estates, all of the property is situated in the State of domicile and no difficulty will be encountered in computing tax credits, by States. Additional administrative work will be involved only in the case of estates containing property the situs of which is outside the State of domicile. In these cases appraisal of value by States will be necessary.

It is contemplated that the proposed Federal credit would largely eliminate the need for dual administration and tax compliance. Perhaps a simple report to each interested State giving notice of death and application for letter of administration, and another final report showing the total tentative Federal tax liability upon all property of the decedent within the jurisdiction of the State, as found by the Commissioner of Internal Revenue, with payment attached for the State's share, are all that would be needed. A State receipt might then be issued in duplicate, one of which the executor or administrator would attach to the balance due the Government. These purely ministerial functions could be handled by mail through some existing State agency at no additional expense, and the cost of compliance would thus be reduced to postage. An option might well be offered the States of relying altogether on Federal collection and remittance of the State's share, at no expense, which would eliminate all pretense of State administration. It seems important, however, that this be made the option rather than the rule.

The form of State enactment would, it is contemplated, be something like this:

> There is hereby imposed upon all transfers of property subject to the jurisdiction of this State, as such transfers are defined by Federal law (citing section and statute), a tax equal to the credits provided and as determined in section — of such act for State taxes paid. The words "subject to the jurisdiction of this State" are hereby defined to mean such transfers as are determined by the Commissioner of Internal Revenue in accordance with the provisions of section — of the Federal law (citing same).

It is believed that such a simple enactment would suffice to avail the State of all advantages to be offered under the proposed Federal crediting device. A reliance by the States upon the Commissioner's determination of transfers within their respective jurisdictions may be agreeable if made under rules of law known to, and found acceptable by, the States in advance, and with the assurance that such determinations do not reflect the whims or varying judgments of one individual. Provision probably should be made for administrative hearings at which interested States would be given opportunity to present facts pertaining to the establishment of tax jurisdiction, with the right of appeal from such decisions.

(f) Operation of the proposed State death-gift tax credit under various assumed conditions.

Condition A.—The State has a minimum death-gift-tax law and fully accepts the conditions of the Federal statute. The decedent's estate is all in one State. No gifts are involved.

1. The Federal Government determines the combined tax.
2. The Federal Government notifies both the State and the taxpayer. (The taxpayer also reports to the State, and the State notifies taxpayer of tax.)

3. The State makes its collection, and the taxpayer uses his receipt for payment, in part, of the Federal tax.
4. Alternatively, the State can request the Federal Government to collect the entire tax, in which case the Federal Government will give a check to the State to cover the amount of the credit.

Condition B.—The assets of the estate are in two States both of which have minimum estate-tax laws. No gifts are involved. The steps are the same as in "A" above, except that the Federal Government prorates the credit between the States according to the value of the assets in each State. Jurisdiction is determined by the Federal Government.

Condition C.—The State has an independent death-tax law not fully utilizing the available Federal credit. Assets of the estate are all in one State. No gifts are involved.

1. The Federal Government determines its tax.
2. The State determines and collects the State tax.
3. The crediting device works as under the present law, except that the new scale of credits, adjusted to the latest revenue act, is applied.

Condition D.—The assets of the estate are in two States, one of which has a minimum estate-tax law and the other an independent schedule not fully utilizing the available Federal credit. The Federal Government determines the tax for the State which has a minimum law. The other State determines and collects its tax independently. The taxpayer can use any State tax receipt, as now, to cover his full Federal credit.

Condition E.—The assets of the estate are in two States. Half of these assets have been given away 10 years before death. Jurisdiction in case of the gift tax follows the same criteria as in the case of the death tax, except that the jurisdiction as of the time of gift shall prevail. States that have no gift tax may still obtain full credit for death taxes against the death taxes collected by the Federal Government.

(*g*) *Infringement of State sovereignty.*

The chief obstacles to be overcome in bringing about the coordination of Federal and State death taxes are, it is submitted, political in character. And the principal political obstacle to be overcome is the objection that the plan of coordination involves encroachment upon State sovereignty by the Federal Government.

Only 15 years ago, in 1926, the States took the position that the Federal Government should withdraw from the field of death taxation entirely. It is a far cry from that point of view to the proposal, in 1941, that the States themselves should withdraw from the field and be content to share in Federal death-tax collections.

Historically, as has been brought out in various studies of the subject, the States have prior claim to the death-tax source. They, rather than the Federal Government, have the underlying title to all privately owned property within their boundaries, as is evidenced by the doctrine of escheat. State courts, rather than Federal, determine the property rights of claimants and the distributive share each shall take of the property of a decedent. The State is, therefore, in a favorable position to collect the tax on property within its jurisdiction.

Nevertheless, a fair appraisal of the situation compels the conclusion that one administration of the death tax should be substituted for the 48 now in existence.[60]

It is desirable that this highly important political aspect of the problem of coordination be considered in some detail in order that all unnecessary political hazards may be avoided.

A study of the several coordinating devices under consideration discloses that State sovereignty will be affected in varying degrees shading off to relatively mild forms of coercion and persuasion.

A loss of sovereignty in its broadest sense would be that occasioned by adoption of a constitutional amendment by which the States would delegate to the Federal Government the sole power to impose and collect death taxes. This, however, is not proposed in any plan of coordination.

Undoubtedly, the *requirement* that States withdraw from death taxation as a condition to participation in Federal revenues constitutes a form of coercion, and, even if justifiable, would be strongly opposed by proponents of States' rights, State tax administrators, and others. The need for avoiding tax conflicts, double taxation, and multiple administrative and compliance costs would have to be clearly apparent and strongly felt to prevail against the inertia, the vested interests, and the arguments of the "State's righters" who would oppose the change and argue for the status quo.

Employment of the crediting device, on the other hand, would appear to take away much of the opposition to coordination of death taxation on the part of those who are on the alert to defend the sovereignty of States against Federal encroachment. The States can be granted precisely the same share of Federal death taxes under the crediting device that they would receive under a shared-tax plan; many of the other objectives of the latter such as elimination of double taxation, tax conflicts, and diversity of burden can be achieved; and the States need not be coerced or bought out of the death-tax field. They would continue to exercise their sovereign authority to impose a death tax, but it would be a tax in simplified form, based upon Federal tax liability within the State, similar to the minimum estate tax now in effect in most States.

As previously pointed out, the States are familiar with the operation of the Federal credit and are not afraid of it. It is believed that the matter of repeal of independent State death taxes could safely be left to the judgment of the individual States, free from any condition or demand of the Federal Government that they withdraw, and that such repeal would gradually, perhaps even quickly, occur as it was discovered that the Federal credit considerably exceeded in productivity, in almost every estate bracket, the State tax presently levied. It is believed that the certainty of increased revenues under an adequate crediting device would meet with favor in most States, and that once the States began to benefit under such an arrangement, the relatively small administrative force normally employed to enforce and collect the death tax would not seek to prevent the ultimate repeal of the independent State tax or have sufficient influence to succeed if they did.

There are some minor aspects of the matter in which a milder form of coercion might be relatively unobjectionable, and definitely worth

[60] See summary of discussion of ineffectiveness of State administration, pp. 474-75.

while. In this connection, there might be considered (1) a requirement that the States shall levy no State tax in excess of the Federal credit, and (2) a requirement that the States must accept a Federal determination of domicile and distribution of those estates which are interstate in character for the purpose of determining the Federal credit to which each estate is entitled.

As to the first, a condition that the States availing themselves of the credit shall impose no State tax in excess of the credit is only slightly less objectionable than a requirement that they withdraw entirely from the field. Either is a restriction upon State sovereignty and would encounter resistance on principle. Moreover, under an adequate credit related to the *current* Federal estate-tax law, such a condition would probably be unnecessary, for the same advantages which it is anticipated would induce the States voluntarily to rely on a State levy equal to the Federal credit would probably suffice to assure continued adherence to the credit. Such a voluntary and self-imposed limitation of the power to tax to the limit is in no sense a restriction of sovereignty.

As to the second requirement, less objection would probably be made. If the States were to rely solely on the Federal credit, the mechanics of determining each State's share in the case of estates located in two or more States are such that the credit to which each State would be entitled must depend upon Federal definitions of tax base rather than upon State definitions. This fact would be apparent to all States, and it is not anticipated that, once the States fall in line with the proposed Federal credit, they would interpose any serious objection to compliance with the necessary mechanical or ministerial provisions without which the whole plan would fail of its purpose. The right to determine domicile is one which the United States Supreme Court perhaps could now assume if it wished, and judging from the efforts of State officials to solve the double-domicile problem, most States would be happy to have it do so. A determination of domicile by another Federal agency, subject, perhaps, to review by the Court, ought not to be any more objectionable.

If serious objection to Federal coercion even in this mild form were encountered, there might be considered as a compromise the insertion in the law of an offer by the Federal Government to administer the death tax for the States or to embark upon a joint administrative program. The offer might provide further that for any State making provision to absorb the full amount of the proposed Federal credit and expressing a desire to avail itself of the administrative services of the Federal Government, the domicile and tax base (for the purpose of computing the amount of Federal credit to which the State shall be entitled) should be determined by the Federal Government. This arrangement would impose no pressure whatever upon the States except such as each State might be willing freely to accept, and ought to meet the objections of the stanchest proponent of States' rights. This latter form of crediting machinery can certainly be recommended for adoption. The stronger program with the credit contingent upon acceptance of Federal determination of jurisdiction is more doubtful because of the pressure involved, but in view of further complications in multiple taxation now developing, it also is recommended.

(*h*) *Summary of advantages of suggested use of the crediting device.*

In summary, the advantages of the proposed crediting device in the light of certain objectives sought are as follows:

1. It would not unduly reduce Federal revenues, and might well lead (because of the broader Federal base) to substantial improvement in this respect.
2. It would increase State revenues substantially.
3. It would avoid coercion as far as possible, and would not require State withdrawal from the field of death taxation, thus sustaining the sovereign authority of the States to impose death taxes.
4. It would be capable of gradual adoption on the part of the States.
5. It would cause the least possible disturbance in State death-tax legislation and would constitute a logical development of the crediting device of 1926.
6. It would hold good prospects of gradually eliminating dual administration and dual tax compliance.

In view of the foregoing, the crediting arrangement as outlined above is recommended as the plan that most nearly meets the requirements of an adequate coordinating device, and, at the same time, holds the best prospect of adoption by Congress and acceptance by the States.

9. REVAMPING THE ENTIRE DEATH-TAX SYSTEM

Death taxation in the United States is very unsatisfactory. It is characterized by very high nominal rates only sporadically effective, by absurdly high exemptions, and by conspicuous incoordination. For many years it was apparent that if inter vivos gifts were exempt from taxation, the death tax would usually apply mainly to the transfers of those who died too suddenly and unexpectedly to put their houses in order. More recently, gifts inter vivos have been subject to special taxation by the Federal Government and some of the States. But the owner of an estate of $100,000 can still make a tax saving of about 90 percent by disposing of half of his estate through gifts. In the case of a $200,000 estate, over 60 percent, and in the case of a $500,000 estate, over 45 percent, is saved if 75 percent of the estate passes by gift. With respect to larger estates, about half of the tax is saved if three-fourths of the estate is disposed of inter vivos. These tax savings, it is submitted, are not only excessive but also capricious in their incidence at the various estate levels.

What is needed to make a sound and productive death-tax system is both integration and coordination, plus the abandonment of excessive Federal exemptions. Considering the need for public revenues and the fact that death taxation is probably less inimical to enterprise than either the personal or corporate income taxes, it is apparent that the case for major revision of the whole death-tax structure is exceedingly urgent.

CHAPTER VIII

SPECIFIC TAXES—Continued
(Excise, Sales, and Pay-Roll Taxes)

A. Tobacco Taxes [1]

1. CHARACTERISTICS OF THE TOBACCO TAX SYSTEM

(*a*) *Development and status of the Federal tax.*

Although the Federal Government made some temporary use of the tobacco tax at the time that Alexander Hamilton was struggling with the problem of State debts, it was during the Civil War that the tobacco tax became a permanent feature of the Federal tax system.

The impressive increase in cigarette consumption during the twentieth century has had a marked effect on tobacco taxation. Per capita consumption was only 35 cigarettes per year in 1900, but by 1941 the number reached 1,427. In 1900 less than 7 percent of the Federal tobacco taxes was collected from cigarette consumers, but by 1940 the proportion had increased to 88 percent.[2]

Total Federal collections for the several tobacco taxes increased from $59 millions in 1900 to $698 millions in 1941. Since July 1, 1940, the tax rate has been 6½ cents on a standard package of 20 cigarettes, 18 cents per pound of manufactured tobacco, and from $2 to $13.50 per thousand cigars.[3]

(*b*) *Development of State and municipal tobacco taxation.*

The taxation of tobacco by States has been a comparatively recent development but it has advanced rapidly in recent years. State tobacco taxation began in Iowa in 1921. Early State laws were strongly imbued with the objective of discouraging the consumption of "coffin nails" by the "cigarette fiend." The early laws were regarded as substitutes for outright prohibition, then in operation in some States. Although this early interest in cigarette taxation has been largely abandoned, it has been replaced by a strong fiscal interest. By 1931, the number of States taxing tobacco had increased to 14 and during the next decade the number more than doubled, making a total of 29 in 1941. Montana repealed its tax in 1939 but Illinois and Maine joined the procession during 1941. The important revenue-raising States, New York, Massachusetts, Illinois, and Wisconsin, are all recent arrivals in the field. Undoubtedly the trend toward tobacco taxation during the 'thirties was accelerated by the depression, but it is probably a secular movement as well as a depression phenomenon.

The facts regarding State taxation of tobacco at the beginning of 1942 are presented in table 68. The table shows that on that date 29 States were taxing cigarettes; 9 were taxing cigars; 7, smoking tobacco; 5, snuff; and 4, chewing tobacco.

[1] Based mainly on a monograph prepared for this study: A. B. Goodman, Coordinating the Taxation of Tobacco Products.
[2] Compiled from Treasury Department, Annual Reports of the Commissioner of Internal Revenue.
[3] Ibid.

TABLE 68.—*Types of tobacco products taxed by the States, Jan. 1, 1942*

State	Cigarettes		Cigars		Smoking tobacco		Chewing tobacco		Snuff	
	Tax	License	Tax	License	Tax	License	Tax	License	Tax	License
Alabama	X	X	X	X	X	X	X	X	X	X
Arizona	X	X	X	X	X	X			X	X
Arkansas	X	X								
California										
Colorado										
Connecticut	X	X								
Delaware										
Florida										
Georgia	X	X	X	X						
Idaho										
Illinois	X	X								
Indiana										
Iowa	X	X								
Kansas	X	X								
Kentucky	X	X		X		X				X
Louisiana	X	X	X	X	X	X				
Maine	X	X								
Maryland		X		X				X		
Massachusetts	X	X								
Michigan		X								
Minnesota										
Mississippi	X	X	X	X	X	X				
Missouri										
Montana										
Nebraska										
Nevada										
New Hampshire	X	X	X	X	X	X	X	X	X	X
New Jersey										
New Mexico										
New York	X									
North Carolina										
North Dakota	X	X		X					X	X
Ohio	X	X								
Oklahoma	X	X	X	X	X	X	X	X		
Oregon [1]	X	X								
Pennsylvania	X	X								
Rhode Island	X	X								
South Carolina	X		X		X		X		X	
South Dakota	X	X								
Tennessee	X	X	X	X						
Texas	X	X								
Utah	X	X								
Vermont	X	X								
Virginia										
Washington	X	X								
West Virginia										
Wisconsin	X	X								
Wyoming										
District of Columbia										

[1] The Oregon law is held in abeyance until a referendum in November 1942.

Source: Ways and Means Committee, Hearings, Revenue Revision of 1940, vol. 1, pp. 772–786; State statutes.

In addition, some 10 cities impose special taxes on tobacco and in a few cases this makes a "three-deep" administration of the tax. Among the cities which have special tobacco taxes are St. Louis, Birmingham, Kansas City, Denver, several cities in Florida, and, until recently, New York City.[4]

States that have general sales taxes, but no special tax on tobacco, usually include tobacco in the base of the sales tax.

Most of the States which tax tobacco products also require the annual licensing of tobacco distributors, wholesalers, and retailers. Varying fees are charged for this. In a majority of States these fees are merely imposed to aid in the administration of the tobacco taxes,

[4] Tax Institute, "Tobacco Taxes," Tax Policy, vol. 9, No. 1, November 1941, p. 7.

and therefore they are often nominal in amount. As of 1942, 29 States required licenses for the sale of cigarettes and 27 of these also levied cigarette taxes. Only New York and South Carolina of the cigarette-tax States did not also require licenses of retailers; only Maryland and Michigan required licenses without also taxing cigarettes. Eleven States required licenses for the sale of cigars.

Cigarette taxes in general were adopted first by the agricultural States, especially the Southern States. Since 1935 there has been a distinct tendency for the nonagricultural States to adopt the cigarette tax; all the Eastern States from Pennsylvania to Maine adopted cigarette taxes during this period.

In fiscal terms, the tobacco taxes are much more important to the Federal Government than to the States. They rank tenth as State revenue producers.[5] However, they are increasing in importance. State collections increased from $11 millions in 1931 to $107 millions in 1941. These taxes are regarded by the States as an excellent supplementary revenue source, and, from the fiscal standpoint, they have the advantage that their yield holds up well during depressions. In 1940 New York with collections of $22 millions, and Pennsylvania with receipts of $12 millions, obtained the largest sums from tobacco taxes; the former received 9.4 percent and the latter 9.1 percent of State revenues from tobacco. In Mississippi only the gasoline tax and sales and use tax exceeded the tobacco tax in relative fiscal importance.[6]

The measure of the State cigarette taxes is normally volume, expressed either in packages of a specified size or in the number of cigarettes. In this respect they resemble the specific excises of the Federal Government. For example, the recently adopted Illinois tax is 1 mill on each cigarette; in Alabama, the tax is 3 cents per package of 10 to 20 cigarettes. Only two States do not measure the cigarette taxes in specific terms. Kentucky's cigarette-tax rate is 1 cent on each 10 cents or fraction thereof of retail price; New Hampshire's tax on all forms of tobacco products—adopted as a substitute for the State property tax—is 15 percent of the retail price. All nine States levying cigar taxes graduate the tax according to the retail price of the product. With few exceptions, the State taxes on other forms of tobacco products are measured according to the retail price of the commodity.

A majority of the States reserve tobacco-tax revenues for State general funds. However, a few States have specifically dedicated the revenues for other purposes. For example, Arizona uses the revenues for social-security purposes; Alabama and Arkansas for schools; Georgia, in part, for Confederate pensions; Kansas, in part, for county purposes, and so on.[7] Despite these and other exceptions it is generally true that the revenues from State tobacco taxes are not tied to particular functions of government.

(c) *Advantages of Federal administration; impediments to efficient State administration.*

The Federal Government has the important strategic advantage in tobacco-tax administration that it can collect from the manufacturer with little expense and small chance for evasion. The tobacco-

[5] Tax Institute, Tax Yields, 1940, p. 48.
[6] Tax Institute, "Tobacco Taxes," Tax Policy, vol. 9, No. 1, pp. 4-5.
[7] Proceedings of the Fifteenth Annual Convention of the National Tobacco Tax Conference, Federation of Tax Administrators, Chicago, 1942, pp. 30-35.

manufacturing business is concentrated in the hands of an extremely small number of companies.

The number of manufacturers in business at the end of 1940, and from whom the Bureau of Internal Revenue collected taxes, is shown in table 69. The State of New York alone deals with almost 10 times as many taxpayers in collecting its cigarette tax as does the Bureau of Internal Revenue in collecting the Federal cigarette tax.

TABLE 69.—*Number of tobacco manufacturers in the United States, Dec. 31, 1940*

Types of manufactures	Number of companies
Tobacco manufacturers:	
Plug tobacco exclusively	3
Twist tobacco exclusively	6
Fine-cut tobacco exclusively	3
Scrap chewing tobacco exclusively	99
Smoking tobacco exclusively	336
Snuff exclusively	16
2 or more kinds	111
Total	574
Quasi-manufacturing except perique	157
Perique producers and dealers	59
Total	790
Cigar and cigarette manufacturers:	
Small cigarettes exclusively	43
Large cigarettes exclusively	0
Small cigars exclusively	1
Large cigars exclusively	3,226
2 or more kinds	50
Total	3,320
Total tobacco manufacturers	4,110

Source: Annual Report of the Commissioner of Internal Revenue, 1941, p. 126.

The task of collecting taxes is even more centralized than the small number of companies in table 69 indicates. They were a total of 66 cigarette factories in the United States in 1940, but some companies operate more than one factory. A very large proportion of the cigarette taxes is collected from the "Big Four" companies; these companies are currently manufacturing the overwhelming majority of cigarettes produced in the United States. The cigarette taxes paid in the calendar year 1940 by 7 plants in North Carolina and 9 plants in Virginia amounted to $466 millions, or over four-fifths of the total cigarette taxes.[8] Thus it is evident that a manufacturer's tobacco tax levied by the Federal Government involves a minimum of direct taxpayers.

By far the greater part of these taxes, at least 90 percent, is collected through the use of stamps affixed to the taxable products.[9] Therefore the administration of the tax is simple and nontaxable tobacco is easily discovered. The taxes have been in effect for such a long time and the industry is so well organized and regulated, that the Bureau reports no major difficulty with respect to tax avoidance.

With only 4,100 taxpayers to deal with, the actual cost of collecting tobacco taxes is extremely low. For the fiscal year ending in 1941,

[8] Annual Report of the Commissioner of Internal Revenue, fiscal year ended June 30, 1941, p. 122.
[9] Bureau of Internal Revenue, Reports of the Miscellaneous Tax Unit Upon the History and Application of Various Miscellaneous Taxes, 1936, pp. 101-102.

the Bureau of Internal Revenue reported that the cost of collecting $698 millions in tobacco taxes amounted to $1,241,285 or less than one-fifth of 1 percent (0.18 percent).[10]

Because of the fact that the taxes cover the entire industry, changes in tax rates on tobacco have little effect on administrative expenses. To illustrate, lowering the personal exemptions for income-tax purposes means an increase in the number of taxpayers filing tax returns and hence a need for additional personnel. Increases or decreases in Federal tobacco-tax rates affect little, if any, the cost of tax administration.

In contrast to the very simple and easy task which confronts the Federal Government in the administration of its tobacco tax, the States have a much more difficult problem. The latter are obliged to collect from wholesalers, and in the case of purchases by retailers across State boundary lines, the collection must be from retailers. In the event of out-of-State purchases by consumers, reliance has to be placed upon the use tax with its notoriously difficult procedure.

State tobacco-tax administration is also relatively expensive. Administration is largely through the application of stamps by a more expensive process than that involved in Federal administration,[11] and one which often represents a substantial proportion of the direct cost of enforcement.[12] There is the additional State cost of examining goods to insure compliance with the tax. Still another factor explaining high State administrative costs is that States usually give discounts on the tax stamps to the tobacco merchants or wholesalers as an allowance for expense associated with the collection of the tax. Discounts range from nothing in a few States up to 10 percent of the value of the stamps. Alabama, Georgia, Mississippi, South Carolina, and Utah allow up to 10 percent; Arizona, Iowa, and Massachusetts make no allowance; Washington and Oklahoma allow 3 percent. An allowance from 5 to 10 percent is most common.[13]

A study of tobacco-tax collection statistics prepared by the Federation of Tax Administrators showed that the gross value of stamps and metering impressions in 20 States amounted to $77,887,810 in the fiscal year 1939; discounts for affixing these stamps amounted to $5,580,767, or 7 percent of gross collections.[14] These discounts alone amounted to more than four times as much as the entire cost of administering all the Federal tobacco taxes. New York's discount of $1.5 millions was approximately $500,000 more than was spent in administering the Federal tobacco taxes in 1941.

There is an abundance of evidence, though not very specific, that evasion and avoidance of State tobacco taxes constitute a serious problem. The nature and techniques of evasion were described in a report prepared by the Committee on Interstate Evasion, National Tobacco Tax Conference.[15] On the basis of this study, Clyde Reeves

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[10] See table 25, p. 307.

[11] The Federal stamps may be inserted inside of the outer wrapping.

[12] J. W. Huston and J. R. Berryman, "Collection and Enforcement of State Consumption Excise Taxes," Law and Contemporary Problems, vol. 8, No. 3, Summer, 1941, p. 517.

[13] Proceedings of the Fifteenth Annual Convention of the National Tobacco Tax Conference, 1941, pp. 30–37.

[14] Preliminary Report of the Committee on Standard Practices of the National Tobacco Tax Conference, Uniform Tobacco Tax Collection Statistics. Research Bulletin No. 59, Federation of Tax Administrators, Chicago, 1940, p. 4.

[15] Report of the Committee on Interstate Evasion of the National Tobacco Tax Conference, Tobacco Tax Evasion Through Interstate Parcel Post Shipments, Federation of Tax Administrators, Research Report No. 6, Chicago, 1939.

estimated that losses through evasion alone were as high as 20 percent of what should have been collected had there been complete coverage. In explaining the evasion, he said, "It is these millions that make profitable the far-flung systematic operations of tax-dodging artists dipping into each cigarette-tax State." [16]

The interstate sale of cigarettes is perhaps the most important method of evading State cigarette taxes. The method of operation is to set up a wholesale cigarette establishment, preferably but not necessarily in a State without tobacco taxes, just across the line from a tobacco-tax State. Agents are then hired to solicit direct orders from consumers in the tobacco-tax State. Prices quoted are usually less than the customary retail price since the State tax is not added. The result is that the consumer makes a substantial saving, especially if he buys in quantity. The cigarettes are shipped either in bulk to the agent and then distributed to the consumer or, in a growing number of cases, are shipped by parcel post directly to the consumer. In some States greater complexity is gained by bringing in a third State; the sale occurs in one State, the shipment is made from a second State, and goods are billed from a third.[17]

In 1939 the Federation of Tax Administrators [18] published a summary of the cigarette tax evasion problem as it existed at that time, a part of which is quoted below:

> Because of the very nature of the evasion process, no accurate figures are available to show how big the leak in tobacco tax administration really is. However, estimates of losses have been made by administrators in at least seven States.
>
> Mr. N. E. Shuffield, supervisor of the cigarette tax division, department of revenue, State of Arkansas, estimated that as a result of parcel-post shipments from other States Arkansas lost about $300,000 during the year, as against a total collection of $1,305,000 in 1937. It has been estimated that the State of Georgia loses over $400,000 per year, as against a total collection of $1,512,000 in 1936. Mr. E. F. Rahm, superintendent of the cigarette revenue department, treasurer's office, State of Iowa, reported that Iowa was losing as much as $1,000,000 for the year 1938 and was collecting only about $1,750,000, with most of the loss arising from interstate evasion. Mr. Paul M. Minus, director of the license tax division, State tax commission, South Carolina, reported in February 1938 that interstate parcel-post shipments of tobacco products to retail dealers alone is causing the State of South Carolina an annual loss of approximately $150,000, as compared with a total collection of $2,218,000 in 1937.

The States have attempted to meet this and similar forms of interstate tax evasion by cooperative efforts, by the enactment of use taxes, and by securing the support of tobacco manufacturers and wholesalers. Despite these attempts, the States have been unable to cope with the interstate problem effectively.

While quantitative data are mostly estimates, it would be conservative to conclude that the State tobacco tax is only 75 to 80 percent effective. The balance is represented by cost of stamps, discounts, other administrative expenses, and evasion.

The evasion is objectionable not only because of the loss of revenue; it involves discrimination and makes a group of petty lawbreakers out of individuals who purchase tobacco by mail and evade the use tax.

[16] H. Clyde Reeves, "Progress Toward Elimination of Cigarette Tax Evasion," Proceedings of National Tobacco Tax Conference, 1939, p. 11.

[17] Ibid., p. 4.

[18] Committee on Interstate Evasion of the National Tobacco Tax Conference, Tobacco Tax Evasion Through Interstate Parcel Post Shipments, Federation of Tax Administrators, Research Report No. 6, Chicago, 1939, pp. 1-2.

The legitimate tobacco merchant also faces destructive competition from those who specialize in circumventing (legally or illegally) the State tobacco taxes. The elimination of these elements of discrimination should have a distinct appeal to the tobacco trade.

(*d*) *Other aspects of the tobacco system.*

Two other aspects of the tobacco tax system deserve comment. One is that the tax is quite regressive in character. Consumption of tobacco in the United States is no longer confined to persons of high income; the product is consumed by forty to fifty million people. The following examples show the amount of the cigarette tax burden on cigarettes in some of the States:

(1) On a package of cigarettes in Arkansas, Louisiana, and Oklahoma, a total tax of 11½ cents is paid, consisting of the Federal tax of 6½ cents and the State tax of 5 cents. In these States, the package-a-day smoker pays an annual Federal tax of $23.73 and a State tax of $18.25, or a total of $41.98.

(2) In Alabama, Georgia, North Dakota, South Carolina, South Dakota, Tennessee, and Texas, the package-a-day smoker annually pays total Federal and State taxes of $34.68, the latter at 3 cents per package.

(3) In 18 States—among them New York and Illinois—the total cigarette tax is 8½ cents per package; in these States the package-a-day consumer pays annual State and Federal taxes of $31.03.

Somewhat similar situations apply to cigars and other forms of tobacco consumption. For example, in Mississippi, a 5-cent cigar bears a State tax of 1 cent and a Federal tax of 2 mills or a total of 1⅕ cents. In this State a cigar smoker using 6 cigars a day would pay a total Federal and State tax of $26.28 a year.

On the assumption that tobacco taxes are completely shifted to consumers, they comprise a heavy burden on the low-income groups, and are probably quite regressive. Although low-income consumers do not spend as much for tobacco as do more prosperous consumers, since the former purchase the cheaper types of tobacco products, we know that tobacco purchases are a significant expenditure for all income groups.

The second aspect to be noted is that the Federal cigarette tax and all but two of the State taxes are specific taxes; that is, they apply to the quantity and not the quality or price of the cigarettes. As matters now stand, the specialty, custom-made, and standard brands bear no higher tax than the 10-cent brands. The Treasury has recommended a differentiation in tax on the basis of price classification. In addition, the States, as previously indicated, discriminate widely and heavily against the cigarette smoker as compared with the consumer of other forms of tobacco. Little can be said for this discrimination, except perhaps that there is hesitation in applying a tax to a commodity the consumption of which is waning. From the standpoint of ability to pay, the cigar smoker is at least as able to support the government as the cigarette smoker—and usually more so.

2. COORDINATION PROPOSALS IN THE TOBACCO-TAX FIELD

(a) Previous proposals for coordination.

Several proposals for tobacco-tax coordination have been presented. These may now be briefly summarized.

Graves-Edmonds plan.—F. S. Edmonds, member of the Pennsylvania State Senate, and Mark Graves, formerly president of the New York State Tax Commission, offered a four-point program for reform in Federal-State tax relations in 1934. As to tobacco taxation, it was recommended that Congress provide for the distribution of 1 cent of the Federal cigarette tax to the States in proportion to population, provided the State withdrew from the tobacco-tax field.

The Doughton resolution.—On January 10, 1933, Chairman Doughton, of the Committee on Ways and Means, introduced a resolution in the House of Representatives calling for the sharing of Federal cigarette-tax collections with the States along the lines provided in the Graves-Edmonds plan. The resolution called for the distribution of one-sixth of the proceeds to the States, provided that neither the State nor any of its political subdivisions (1) imposed, collected, or had in force any excise, occupational, or other tax or fee on the manufacture or sale of cigarettes, or (2) had in force any prohibition on the manufacture of cigarettes or the sale thereof to adults, or (3) had in force any law, statute, or ordinance imposing such a tax or fee or providing such a prohibition in respect of any later period.

Interstate Commission on Conflicting Taxation.—The financial implications of the Doughton resolution were analyzed for the Interstate Commission on Conflicting Taxation by Clarence Heer. The principal results of the study were summarized as follows: [19]

> The data developed in the present report indicate that State tobacco taxes operate to reduce the cigarette tax revenues of the Federal Government. On the basis of conditions prevailing in the recent past, it is estimated that an additional tax of 2 cents per package on cigarettes reduces the consumption of cigarettes by 5 percent. It is estimated, further, that when the average State imposes a 2-cent cigarette tax, the Federal Government loses 15 cents through reduced cigarette consumption for every dollar of new tax revenue collected by the State.
>
> * * * * * * *
>
> State tobacco taxes undoubtedly diminish the yield of the Federal tobacco tax. Up to the present, however, with only 15 States imposing these taxes, the loss of Federal revenue is far from equalizing the sum of 55 million dollars which the Doughton resolution would require the Federal Government to distribute among the States. From a purely revenue standpoint the adoption of the Doughton proposal would not be profitable to the Federal Government at this time. It is not beyond the bounds of possibility, however, that State tobacco taxes may at some future time reduce the consumption of cigarettes by as much as a sixth. If this is regarded as a likely contingency, the Doughton resolution may perhaps be justified as an insurance measure.

Heer listed four arguments that were advanced by the proponents of the Doughton resolution: (1) The tobacco-tax revenues of the Federal Government would be stabilized and preserved; (2) the cost to the Federal Government would constitute an insurance against further State encroachment in the tobacco-tax field; (3) States would be supplied with much-needed revenue; and (4) consumption would be stimulated by relief from State tobacco taxation and the tobacco farmers would be benefited by the resulting expansion of sales.

[19] Clarence Heer, Coordination of Federal and State Tobacco Taxation, American Legislators' Association, Chicago, 1934, pp. 1-2.

Against the Doughton resolution, Heer also listed four main arguments: (1) There is no indication that repeal of State tobacco taxes would stimulate cigarette sales sufficiently to compensate the Federal Government for the surrender of one-sixth of its cigarette-tax receipts; (2) the chances that all States will adopt cigarette taxes are exceedingly remote; (3) there is no guaranty that States which are now collecting more under their present tobacco taxes than they would receive from the proposed Federal distribution would elect to accept the provisions of the Doughton resolution; (4) the per capita consumption of cigarettes is higher in the urban and industrial States than in the predominantly agricultural States; because of this the division of a part of the proceeds of the Federal cigarette tax among the States on a basis of population would force citizens in the industrial States to contribute toward the cost of purely State and local functions in the less industrialized States.

The conclusion of Heer and of the Commission on Conflicting Taxation was that "no additional tobacco taxes [should] be imposed by the States for revenue purposes."

Since the time that Heer wrote his report on coordination of tobacco taxation in 1934 and the Commission on Conflicting Taxation made its recommendations in 1935, the tobacco-tax situation has changed considerably. Heer reported that there were 15 States with cigarette taxes; these States contained only 29 percent of the population of the country and accounted for considerably less than that proportion of the total consumption of cigarettes.[20] A year later the Commission on Conflicting Taxation reported State tobacco taxes in 19 States which contained 41 percent of the population of the country. At the present time (1942) 29 States tax cigarettes, and their area embraces 67 percent of the population. These States now account for an even larger proportion of the total consumption of tobacco products. As contrasted with 1934 and 1935, the State cigarette taxes are no longer confined principally to the agricultural States where average consumption of cigarettes is known to be below the national average. At the present time there are more agricultural States than industrial States without cigarette taxes. The result is that the conflict between the Federal Government and the States has grown since 1935 until it now probably applies to as much as three-fourths of the consumption of cigarettes.

(*b*) *Arguments for and against the application of Federal-collection-State-sharing to the tobacco tax.*

The type of coordination most readily applicable to the tobacco tax field is Federal collection and State sharing. None of the other coordination devices appears to offer attractive possibilities. Separation of sources, giving the Federal Government the tax perhaps in exchange for a State monopoly of the gasoline tax, could be defended as an academic proposition, but it could hardly be achieved short of a constitutional amendment, with all the ensuing political hazards. Other coordination devices fail to solve the problems of State administration.

The tobacco tax offers an ideal field, in most respects, for Federal collection and State sharing. Here is a case where the Federal Government has a marked advantage in administration, where the

[20] Heer, op. cit., p. 14.

State tax, with some exceptions, is fairly uniform and rapidly becoming general, and where a formula of distribution (per capita) free from too much political manipulation can readily be found. Trouble may be anticipated in adjusting a distribution scheme to the needs of States with a high rate of tax, but a distribution of 2 cents per package of cigarettes would involve an increase in State revenues for a majority of the tobacco-tax States. If an additional concession were necessary, existing collections could be used as a minimum, with perhaps a provision to reduce gradually and eventually to eliminate this special treatment, in perhaps 10 years. The principal objection to sharing taxes is that the Federal Government should not dictate to the States what their tax systems should include and certainly should not encourage the use of a regressive tax. But the degree of dictation involved in this instance would not be very serious. The extension to nontaxing States merely anticipates a very strong trend. Injury to the industry is less likely under a coordinated uniform plan than with present arrangements. Regressivity in this instance is somewhat counterbalanced by the optional and nonessential character of the consumption.

The tobacco tax is much better adapted to sharing than either the liquor tax or the retail sales tax. For the liquor tax, local differences are more pronounced and of greater sumptuary significance. For the sales tax regressivity is not offset by the fact of nonessential and in some cases perhaps harmful consumption.

If tobacco taxes could be returned to the States in proportion to tobacco consumption, the States would share approximately in proportion to their contribution to Federal tobacco taxes, and roughly in proportion to the revenues they might collect for themselves. Unfortunately, consumption figures are not available. Because of the fact that there are a considerable number of distributors selling across State lines in each of the States, even the tobacco companies do not have an accurate record of consumption in each State. Perhaps the Treasury Department could make reasonably accurate estimates of consumption by States. It seems probable, however, that the formula adopted would be one based on the population of the respective States. Since consumption of cigarettes is not uniform throughout the country, a distribution formula based on total population would tend to penalize the heavy cigarette-smoking industrial States in favor of the tobacco-chewing and pipe-smoking agricultural States. On the other hand, the agricultural States, particularly the Southern States, tend to tax tobacco more heavily, and consequently have more to lose in any sharing program that fails to take account of their high tax rates.

One suggested modification in the population distribution formula is to give greater weight to urban population than to rural population. Perhaps giving urban population a weighting of 150 percent would be sufficient to allow for differences in tobacco consumption.

(*c*) *Amount to be shared and method of distribution.*

The proportion of tobacco taxes to be distributed to the States might be determined in one of several ways. The proceeds from the application of a rate equivalent to that most commonly used by the States might be used; with cigarettes this would be 2 cents per standard package of 20 cigarettes. A fixed percentage of Federal collections might be apportioned to the States. Finally, a fixed amount might be shared.

With regard to cigarette taxes, it is believed that the best plan would be to distribute the yield of a Federal tax of 1, 2, or 3 cents per package. This method of sharing would permit the Federal Government to vary its total rate as much as it pleased, so long as a rate sufficient to cover the States' share were still retained in the Federal tax system. This arrangement would also allow States to share in the increase in total tax collections that will arise from the increasing annual consumption of cigarettes; and the States would also share the burden of any decline in cigarette consumption, such as, for example, occurred in the first few years of the 'thirties.

Potential State receipts from a 1-cent-per-package sharing plan would amount to $89 millions or approximately 91 percent of actual 1940 State tobacco-tax receipts.[21] Had all the States been levying tobacco taxes, it is probable that the 1-cent shared tax would have produced only about one-half to three-fifths of 1940 State receipts. A 2-cent-per-package sharing plan would yield $178 millions to the States or 182 percent of the actual receipts of 25 States in 1940. Had all the States been levying tobacco taxes, it is probable that the 2-cent shared tax would have produced from 100 to 125 percent of actual receipts. To complete the comparison, a 3-cent-per-package sharing plan probably would yield the States $267 millions or 273 percent of 1940 receipts. Of these three proposed rates, the 2-cent sharing plan is favored as most nearly approximating current receipts, while still giving sufficient room for an inducement to the States to approve the coordination plan.

In order to see how the 2-cent sharing plan would affect the receipts of existing tobacco-tax States, an analysis has been made of the amounts that would be received by each State under different schemes of distribution. Using 1941 Federal revenue collections, the amounts that would be distributed to the States from (*a*) the yield from 2 cents of the cigarette tax, and (*b*) the yield from 50 percent of the Federal tax on other types of tobacco products have been estimated. The total sum amounts to approximately $228 millions. All the States would receive their proportionate part of the tobacco taxes, regardless of whether they levied a tobacco tax prior to the effective date of the sharing plan. Owing to the fact that data were available for only one-half the States (the other being excluded because of no tobacco-tax levies, or because of incomplete fiscal years) the following comparisons are restricted to these States.

Two apportionment formulas have been tried out. The first would distribute revenue to each State according to its percentage of the total United States population; the second, according to a weighted population formula. Under the latter proposal, because of the greater consumption of cigarettes in urban areas, urban population (in cities and villages over 2,500, 1940 Census) in each State was given a weight of 1.5 as compared with a weight of 1 for rural population.

Table 70 shows for both formulas the proportion of current tobacco tax receipts that would be received by the States from a Federal-shared tax. When total population alone is used, 6 States would not receive as much tobacco tax revenue as they received in 1940; all these, except Louisiana, are located in the northeastern part of the United States.

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[21] Revenue data were available for only 25 States.

Under the first plan, Louisiana would receive only about three-fourths of its current tobacco-tax receipts. Five States would receive over 200 percent of current receipts if the proposed amount were distributed according to unweighted population.

TABLE 70.—*Proportion of 1940 State tobacco tax receipts that would be received by 24 States from federally shared tobacco tax distributed according to unweighted total population, weighted urban population* [1]

State	Percent of 1940 State receipts	
	Unweighted total population formula	Weighted urban population formula
A. States receiving more by weighted formula:		
1. Connecticut	98.3	102.0
2. Massachusetts	94.3	106.3
3. New York	98.0	108.0
4. Ohio	110.3	114.7
5. Pennsylvania	138.2	143.6
6. Rhode Island	99.2	113.9
Simple average	106.4	114.8
B. States unaffected by weighting:		
1. New Hampshire	85.4	85.4
2. Utah	274.6	274.6
C. States receiving less by weighted formula:		
1. Alabama	137.1	123.1
2. Arkansas	197.6	171.0
3. Georgia	176.7	161.8
4. Iowa	209.3	198.4
5. Kansas	242.9	228.7
6. Kentucky	263.2	236.4
7. Louisiana	73.0	68.5
8. Mississippi	136.2	116.5
9. North Dakota	205.1	175.8
10. Oklahoma	157.5	145.1
11. South Carolina	117.0	102.3
12. South Dakota	167.8	147.3
13. Tennessee	157.3	143.9
14. Texas	139.8	133.7
15. Vermont	129.1	119.6
16. Washington	134.9	132.9
Simple average	165.3	150.4

[1] Distribution of 2 cents per package of Federal cigarette tax receipts and 50 percent of the yield of other tobacco taxes for fiscal year 1941.

If the weighted urban population is used, 6 States, generally recognized as urban, would receive more than with the first formula, 2 States would receive the same, and the 16 more rural States would receive less. One other effect of the weighted formula is that only 2 States would not receive as much from the shared tax as they are currently receiving from the existing State levy; Louisiana would receive less than either current State receipts or the amount that would be received with the unweighted population formula.

A comparison of the urban States with the rural States seems to indicate that the proposed allowance in the weighted urban population formula is not sufficient properly to credit the urban States for their heavier smoking. On the one hand, a simple arithmetic average of the percentage of 1940 actual receipts with the weighted population formula that would be received by the States favored by the weighted formula reveals an average of 114.8 percent as compared with only 106.4 percent when the unweighted formula is used. On the other hand, in the 16 States in which the weighted population formula would reduce the amounts received by the States as compared with the unweighted population formula, the simple average is 150.4 percent for the weighted population formula and 165.3 percent for the unweighted population formula.

Even with the weighting of urban population by 150 percent, the difference between potential receipts and actual receipts is much larger in the 16 more or less rural States than in the 6 urban States. This difference is large enough to suggest that possibly a weighting of 200 percent for urban population would more nearly approximate current receipts and somewhat narrow the distance between the amounts that would be received by the urban as compared with the rural States. An examination of the data for the 16 rural States indicates that probably only South Carolina and Louisiana would not receive as much with the formula weighting urban population 200 percent as is received from current State tobacco taxes. For these 2 States it is possible that some kind of minimum guaranty would have to be incorporated in this coordination plan in order to receive their support.

It does not appear that conversion of the tobacco taxes to an ad valorem basis would require radical changes in a Federal-State tobacco-tax-sharing plan. Instead of allowing the States a definite proportion of the Federal tax—for example, one-fourth—the sharing plan might provide that the States receive the yield from a tax of 50 percent of the wholesale price of cigarettes. This would be more desirable than giving the States a percentage of the Federal tax; it would permit the Federal Government to modify its own tax in terms of budgetary needs without raising or lowering the total yield to the States. Giving the Federal Government the exclusive authority to modify the total tax rate is especially desirable; it must carry the major burden of war and depression and, therefore, must be able to raise or lower consumption taxes in the light of business conditions and need for public revenue.

It is probable that a Federal tax of 200 percent of the wholesale price of cigarettes would produce roughly the same amount as was obtained from both Federal and State taxation in 1940. For example, the average wholesale price of cigarettes per 1,000 was $2.38 prior to 1937 and $2.51 from 1937 to 1940.[22] At the price prevailing during the latter period, a wholesale tax of 200 percent would have produced a tax of $5.02 per 1,000 cigarettes. If the States were allowed to share in the tax to the extent of one-fourth of the proceeds, the amount distributed would be approximately $1.25 per 1,000 cigarettes or 2½ cents per standard package. It is believed that this amount would be sufficient to compensate the States for withdrawal from the tobacco-tax field, provided an equitable distribution formula were adopted.

For those States currently receiving more from State tobacco-tax revenues than would be provided by the sharing plan, undoubtedly some provision would have to be made to facilitate the change-over to a federally shared tax. Of course, over a period of time the increase in consumption of tobacco should tend to narrow the gap between 1940 yields and amounts that would be received under the sharing program. Between 1930 and 1940, total consumption of cigarettes increased approximately 54 percent; if this rate of increase continues during the present decade, the additional yield from tobacco taxes even with unchanged rates will more than be sufficient to wipe out

[22] U. S. Department of Agriculture, Annual Report on Tobacco Statistics, 1940, table 6. Prices are exclusive of Federal tobacco excise taxes.

any difference between 1940 receipts and receipts distributed under a 2-cent sharing program.

This process would take some time, and it is probable that the States would be reluctant to accept the shock of an immediate cut in tobacco-tax revenues. In order to make some allowance for the difference between actual receipts and shared receipts, it is proposed that the integration plan provide for a guaranty of 100 percent of collections during the first year and a reduction of the guaranteed sum by 10 percent a year until per capita distribution exceeds the guaranteed sum.

(*d*) *Timing the tobacco coordination program.*

The inauguration of a Federal and State tobacco tax coordination plan requires that some attention be paid to the proper timing of such a program.

During the war.—It would appear that the wartime emergency is an excellent time to consider a tobacco-tax coordination plan. Several arguments can be urged in support of this position. First, the Federal Government may very well consider a significant wartime increase in the tobacco taxes. If it is going to adjust its own rates anyway, it might be advantageous to include an extra levy to cover the added cost of sharing part of the yield with the States. Second, State tax yields in the past 2 years have increased considerably owing to improved business conditions. States therefore would not suffer greatly from any small losses that might occur from agreement on a sharing program. And third, as a result of increased incomes, tobacco consumption is up 10 to 20 percent during the present year as compared with last year. Part of the net reduction in Federal tax yields would thus be offset by increases in tobacco consumption.

After the war.—If the tobacco coordination plan were launched after the end of the present world conflict, slightly different procedure might be necessary. Provided that present and contemplated increases in tobacco taxes were still on the statute books, it would be probable that there would be considerable agitation for a reduction of the internal excises, including the tobacco taxes. At least that has been the nation's experience after the close of previous wars. The reduction might then take the form of elimination of the State taxes through the inauguration of sharing.

The question remains whether, if the States are to continue in the tobacco-tax field, the Federal Government should not extend its full cooperation to State officials in the enforcement of State laws. This would probably mean Federal legislation requiring postal packages carrying tobacco products to be labeled and permitting inspection by State officials. President Roosevelt on one occasion expressed concern that "a Federal agency, the postal service, should be used as an avenue for evading the payment of taxes levied by a State." [24] The President added that he would "not be opposed to Federal legislation so restricted as not to open the doors to abuse, but broad enough to accomplish your purpose." [25]

A solution along the line supported in the President's letter is worth further consideration, but it seems of very doubtful administrative feasibility.

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[24] Letter from President Roosevelt to T. Grady Head, Georgia revenue commissioner, dated July 9, 1937, quoted in Report of the Committee on Interstate Evasion, National Tax Conference, "Tobacco Tax Evasion Through Interstate Parcel Post Shipments," Federation of Tax Administrators, Research Report No. 6, Chicago, 1939, p. 11.

[25] Ibid.

B. Liquor Taxes [26]

1. SUMMARY OF THE SYSTEM

The general facts about liquor taxation may be summarized as follows:

1. The field is a very lucrative source of revenue yielding all units of government well over one billion dollars.
2. Duplicating taxation in the alcoholic beverage field extends to all three levels of government, to the specific excises levied on the several products, to the occupation and license taxes exacted from businesses engaged in various branches of the alcoholic beverage trade, and to the three principal types of alcoholic beverage products—distilled spirits, wine, and beer.
3. The Federal Government collects nearly two-thirds of the total revenues.
4. Diversities in State liquor tax patterns include the application of modified prohibition in three States—Kansas, Mississippi, and Oklahoma—which allow only liquors of low alcoholic content to be sold. Many of the States classified as wet allow local option as to the prohibition of local sales. There is also great diversity in tax rates. State rates on beer, for instance, range from 50 cents per barrel (31 gallons) in the District of Columbia and 62 cents in California, Missouri, Nevada, and Wyoming to $5 in Arkansas and $6.61 in Mississippi.

Excises on liquor products are seldom employed by local governments. However, there are municipal excises in New Orleans of 40 cents per gallon on distilled spirits, 5 cents to 40 cents on wine, and 40 cents per barrel on beer. Garret County, Md., taxes beer at 2 cents per pint bottle. Certain local governments in Arizona and Utah are also empowered to employ local liquor excises.[27] Revenues collected from such municipal levies are of little consequence, the most productive perhaps being that of New Orleans, which yielded slightly over $1 million in 1940.[28]

Second in fiscal importance to the State liquor excises, are the various types of license fees levied by 47 of the 48 States. These licenses apply to a wide range of activities connected with the liquor business, and, while intended to be regulatory in character, they are also productive of considerable revenues. The Distilled Spirits Institute reported State license fees of $57 millions in 1940, amounting to about one-sixth of net State alcoholic beverage revenues.[29]

Licenses or occupational taxes are levied by either the State or local governments, and not infrequently by both. The licenses issued by the States include those for some or all of the following: Distillers, rectifiers, package stores, hotels, night clubs, caterers, restaurants, drug stores, clubs, warehouses, still manufacturers, brokers, and nonresident manufacturers. These license fees range from as low as $1 on domestic wine manufacturers in Arkansas to $7,500 on distillers in New York.[30]

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[26] Based mainly on a monograph prepared for this study: A. B. Goodman, Coordination of Taxation in the Alcoholic Beverage Tax Field.

[27] C. F. Conlon, "Taxation in the Alcoholic Beverage Field," Symposium on Alcoholic Beverage Control, Law and Contemporary Problems, vol. 7, No. 4, Autumn, 1940, p. 735.

[28] Distilled Spirits Institute, Public Revenues from Alcoholic Beverages, 1940, Washington, p. 21.

[29] Ibid., p. 5.

[30] C. Conlon, op. cit., p. 736.

A large number of States have a monopoly on various parts of the liquor business, especially as applied to the retail distribution of distilled spirits, less often to wine, and seldom to beer. These States depend largely on profits from their monopolies, rather than taxes, for revenues.

5. A major concern in liquor taxation is the elimination of bootlegging. While the amount of illegal traffic is said to be decreasing, the number apprehended and convicted on bootlegging charges is still very high. Some estimates put the amount of the illegal traffic in hard liquor as high as 25 to 50 percent of the total trade,[31] although there is no way of verifying these figures. Inaccessibility of materials may put an end to tax evasion during the war.

6. The liquor-traffic field is perhaps the one business most heavily clogged with trade barriers. The twenty-first amendment empowers the States to exercise virtually complete regulation over liquor imports, and takes precedence in this respect over Federal constitutional provisions which might otherwise prevent discrimination. This immunity, intended to facilitate regulation, has been used by 43 of the States [32] not only for the purpose intended but also to protect home industry, retaliate against discrimination by other States, and favor some States as against others. These discriminations are accomplished by means of differential license fees and taxes, and by requiring certificates of approval for out-of-State sources.

7. The liquor tax field is one in which Federal-State cooperation as to administration has been highly developed with quite salutary results. Efforts to hunt out the bootlegger have been characterized by joint use of facilities and information to a remarkable extent. In this respect the field furnishes an example of collaboration which might well be cultivated elsewhere.

Although the Federal Government experimented with liquor taxation before the Civil War and made steady and increasing use of this source from then to the prohibition era, while at the same time State and local governments raised liquor-tax revenue by means of license fees, most liquor-tax problems, and especially the coordination problem, have arisen since prohibition repeal. In two respects preprohibition experience with liquor taxation at the State and local level resembled present practice. One was the diversity of State procedure and the other was the degree to which taxation was mixed with regulatory objectives. The instability of State and local policy appears to have been greater then than now. The experience of one State has been summarized as follows:

> A century of liquor legislation in Massachusetts can be broken up into the following approximate periods: 12 years of stringent license, 8 years of qualified prohibition, 16 years of the so-called Maine type of prohibition, 1 year of high license with local option, a 6-year return to modified prohibition, 13 years of low license, 18 years of high license, 12 years of high license with local option, and finally prohibition.[33]

[31] Elizabeth L. Lamont, "The Bootlegger is Still With Us," The Journal of Commerce and Commercial, vol. 187, No. 14,441, January 24, 1941, p. 20.
[32] Thomas S. Green, Jr., "The Liquor Tax as an Interstate Trade Barrier," The Journal of Commerce and Commercial, vol. 187, No. 14,441, January 24, 1941, p. 40.
[33] R. B. Fosdick and A. L. Scott, Toward Liquor Control, New York, 1933, p. 2.

2. PROPOSALS FOR LIQUOR-TAX COORDINATION

When it became evident in 1933 that the national prohibition amendment would be repealed, a number of studies were launched for the purpose of anticipating the problems that would be encountered by American governments with repeal. The Fosdick-Scott study recommended that the manufacture of alcoholic beverages be taxed exclusively by the Federal Government.

It was suggested that the practical method of accomplishing federalization of the manufacturers' excise tax was through an interstate and Federal arrangement whereby the participating States—

> * * * agree to refrain from such levies while the Federal Government agrees to meet the costs of administration and distribute to the States, for example, 20 percent of the amounts collected. Such distribution should, perhaps, be in proportion to the taxes collected within the several States.[34]

Regarding State taxation, Fosdick and Scott recommended a liquor-sellers' tax consisting of two elements: One, a small flat license of not more than $250; two, an excess-profits or income tax to be computed after all other tax payments. Those States with State liquor monopolies would obtain their revenues in the form of profits, rather than from taxation.

The Interstate Commission on Conflicting Taxation, at the time the eighteenth amendment was repealed and prior to any Federal legislation, adopted a resolution urging that gallonage taxes, whether direct or indirect, should be imposed only by the Federal Government. It was recommended that of the combined gross revenue from the liquor traffic, one-half should inure to the benefit of the States and their localities and the remaining half should be retained by the Federal Government. In the case of those States which adopted a State monopoly plan of liquor distribution, the actual profits derived from State liquor transactions were to be considered as equivalent to State taxes.

Regarding the distribution formula, the Commission recommended:[35]

> "That the Federal Government should ascertain its total gross revenue from the liquor traffic derived from all sources, and divide that amount by the total population in all the wet areas in the United States, thus establishing the Federal per capita. Similarly each State should ascertain its total gross revenue, including both State and local proceeds, and divide that amount by the total population in all the wet areas in the State, thus establishing the State per capita. In the case of each State, the State per capita and the Federal per capita should then be added, thus establishing the combined per capita for that State. The State's minimum share should be one-half of the combined per capita. Accordingly, the Federal Government should make payments to each State which contains wet areas, in accordance with the following formula:
>
> Ascertain one-half of the combined per capita. Subtract from that amount the State per capita. Multiply the difference by the number of the total population in all of the wet areas in the State, thus arriving at the amount to be paid by the Federal Government to the State."

[34] Ibid., p. 122.
[35] Conflicting Taxation, the 1935 Progress Report of the Interstate Commission on Conflicting Taxation, p. 6.

In 1934 Mark Graves, president of the New York State Tax Commission, and Franklin S. Edmonds, of Philadelphia, collaborated in the preparation of a tax-coordination program. The liquor tax was one of the four taxes included in their program.[36]

There can readily be observed in the conditions described above strong grounds for a program of Federal collection and State sharing, such as has been advocated of tobacco taxation. In support of this program it can be argued that the diversity of State taxation and the trade barriers are bad for the liquor industry—particularly the legitimate portion of the industry. Enactment of Federal and State laws, without much attention by Congress and the State legislatures to what each is doing, may have resulted or may result in some excessive combination of rates beyond the point of maximum revenue and of good administration. Finally, the States may feel that the present system gives the Federal Government more than its full share of liquor-tax receipts.

However, the difficulties and objections to the application of a shared tax in this field are impressive. The diversity of State practices which, on the one hand, serves as a reason for sharing, constitutes, on the other hand, a major difficulty in arranging such a program. Taxation in the liquor field is closely tied to regulation, which, under the twenty-first amendment, was deliberately changed from national standardization to State determination. It is probable that much of the sentiment which overthrew national prohibition could also be mobilized against federalization of the liquor taxes, even if the plans provided for Federal-State sharing. A national policy on liquor taxation or regulation does not exist, and there are great territorial differences of opinion on the subject. There are long-standing differences in tastes that result from national origins, climatic conditions, advertising outlays, religious, and other social pressures, differences in average income or income distribution, nontax restrictions on sales, retail prices, and so on. It was precisely such situations as this that the program granting State opportunities for self-expression was designed to cover. Legislation, to be enforced, must have the support of local public opinion.

If a tax-sharing program proved too difficult in 1934 to achieve enactment, it is hardly likely to be easier in 1942. That it would meet with very strong and general opposition is apparent from the comments of State administrators. Moreover, the program is probably inadvisable even if it were feasible.

Other methods of coordination are conceivable; among them, separation of sources (either the Federal Government or the States to withdraw from the field) and delegated administration. These involve so many obvious difficulties that they may be dismissed without further discussion as impractical. As previously observed, a high degree of administrative collaboration in this field has already been achieved.

Although no major recommendations can be made concerning improved intergovernmental relationships in the liquor-tax field, the following are submitted as promising some improvement:

1. Federal occupational and license taxes are an unnecessary complication in an already highly complicated liquor-tax field and should be eliminated.

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[36] See p. 82.

2. The attack on trade barriers, already begun, should be carried on vigorously. This is a field where education is the major available instrumentality of improvement. Both business groups and the public can be made to see the damaging effects of liquor-trade barriers.

3. When other means of coordinating the tax system fail, it does not follow that coordination by forbearance is impossible. States should attempt to make State tax burdens on the liquor business as uniform as possible and States and the Federal Government should legislate and administer with each other's taxes in view. Cooperation among administrators in the liquor-tax field is a shining example for others to emulate.

C. Gasoline and Motor Vehicle Use Taxes [37]

1. MOTOR-FUEL TAXES

(a) *Introduction.*

Our economy and fiscal systems have been geared to the automobile more than many have realized. For the nation as a whole, gasoline taxes are the fourth most important source of governmental revenue, outranked only by the property, pay-roll, and income taxes. Of the overlapping taxes, the gasoline tax ranks next to income taxes and pay-roll taxes in importance. The yields for 1940 and the extent of the overlapping can be seen in the following figures: [38]

	Yields	Percent of total yield from this tax
Federal	$257,420,000	23
State	852,674,478	76
Local	4,500,000	1
Total	1,114,594,478	100

Local taxation of gasoline occurs in only seven States and occupies a place of minor fiscal importance in the field. But as a result of the multiple taxation of gasoline by three different levels of government, the combined tax rate is sometimes very high. In seven States—Alabama, Florida, Mississippi, Missouri, Nevada, New Mexico, and Wyoming—local gasoline taxes levied by counties, cities, or other municipal governments add considerably to the burden of the total tax.

These combined levies in 1941 ranged from a low of 3½ cents in the District of Columbia and Missouri to a high of 10½ cents in parts of Alabama and Mississippi. In other words the combined tax levy on gasoline in portions of these two States was three times as high as that in the District.

Although interest in the taxation of gasoline was first expressed by officials of the Federal Government, the tax itself was first applied by the States and has been most highly developed by the latter.

[37] Based upon monographs prepared for this study: A. B. Goodman, Coordination of Federal and State Gasoline Taxes; and, Coordination of Federal and State Use, Property and Registration Taxes on Motor Vehicles.
[38] Tax Yields, 1940, Tax Institute, Philadelphia, 1941, p. 27.

The States entered the field with the enactment of the Oregon law in 1919, and from then on the history of the gasoline tax in State revenue systems was one of rapid development, both intensive and extensive. By 1929 all States were in the field and the now predominant rate of 4 cents per gallon had become quite well established. However, further development took place during the thirties. In 1931 there were only 3 States with gasoline taxes exceeding 5 cents per gallon, but in 1941 this number had increased to 15. By 1941 only Missouri and the District of Columbia had tax rates as low as 2 cents per gallon. Three States (Florida, Louisiana, and Tennessee) had 7-cent rates. The high-rate States were concentrated in the South and Northwest.

A Federal gasoline tax was first proposed in 1914, when the House Ways and Means Committee unsuccessfully advocated a levy of 2 cents per gallon. Congress also failed to heed President Wilson's recommendation for a Federal gasoline tax in 1915, and again rejected a similar proposal in the revenue bill of 1918. Following this last rejection, it was 14 years before a Federal tax was again proposed, this time in 1932. In the meantime the States had developed this source of revenue, and were obtaining from it over one-half a billion dollars annually.

The first Federal gasoline tax, inaugurated in 1932, was considered as an emergency tax and was roundly condemned by the States, representatives of highway-user organizations, and the petroleum industry, as an unwarranted invasion of the State tax field. In the Revenue Act of 1932 the Federal tax rate was placed at 1 cent per gallon with no exemptions or refunds. Under the National Industrial Recovery Act, however, this rate was increased to 1½ cents effective June 18, 1933. Beginning with January 1, 1934, this rate was reduced to 1 cent where it remained until again raised to 1½ cents in the Revenue Act of 1940.

Thus the motor-fuel tax was first enacted and has been most highly developed by the States. The above data on yields somewhat understate the importance of this tax to the States—it represents a much larger proportion of State than of Federal revenues. Federal gasoline taxes collected in 1940 amounted to 5 percent of total Federal tax revenues. In comparison, State gasoline taxes amounted to 26 percent of State tax collections and were almost twice as important as the next most important class of State taxes. State gasoline tax collections were over 3½ times those from either State property taxes or alcoholic beverage taxes. They yielded more than twice as much revenue as did either State income taxes or automobile license fees, and almost twice as much as State sales taxes. The tax proved a very stable element in State tax systems, a matter of considerable importance in view of the scant means of adaptation to cyclical fluctuations that most States possess. Moreover, the States have the primary responsibility for highways, with which the State motor taxes are closely associated.

(*b*) *Nature of the Federal and State taxes.*

(1) *Federal tax an emergency levy enacted over the protest of State and other interests.*—Mention has been made of the circumstances under which the Federal Government entered the gasoline tax field and the strong opposition to this move.

The Senate Finance Committee in 1933, as well as in 1935, recommended repeal of the Federal gasoline tax on grounds that it was an unwarranted invasion of a field of taxation formerly reserved to the States. Speaking of the Federal excises, including gasoline taxes, the Committee in 1935 stated:

> Our committee, while recognizing that many of these taxes are objectionable features, strongly urges that these taxes be temporarily extended for a period of 2 years without change. Action on the part of the Congress to remove these taxes at an earlier date or to revise same will not be foreclosed by the passage of this joint resolution.[39]

The Interstate Commission on Conflicting Taxation in 1933 strongly urged the Federal Government to relinquish the gasoline-tax field to the States:

> Since Congress has declared that the Federal tax on gasoline was levied only as a temporary expedient on account of the emergency, the commission urges the Federal Government to relinquish this source of revenue for the exclusive use of the States at the end of the next Federal fiscal year—namely, June 30, 1934.[40]

The petroleum industry likewise has voiced its opposition to Federal taxation of gasoline. Gen. Baird H. Markham, director of the American Petroleum Industries Committee, speaking before the North American Gasoline Tax Conference in 1938, said:

> The petroleum industry insists that gasoline shall be taxed once only, and then by the States; that revenues derived from a tax imposed for the specific purpose of financing highways shall be used for no other purpose whatsoever.[41]

The Council of State Governments is also on record in opposition to Federal taxation of gasoline. In 1937 a resolution was adopted as follows:

> *Resolved*, The original temporary emergency nature of the Federal gasoline tax, improving yields from Federal levies, the vital importance of gasoline taxes as State revenue sources, and the essential role of gasoline as a commodity utilized in transportation and communication, prompt the Third Interstate Assembly of the Council of State Governments to request and urge that the Congress of the United States relinquish this recognized field of State taxation at the termination of the current fiscal year, or as soon thereafter as possible.[42]

(2) *Federal tax a general excise not closely related to benefit taxation.*—Although much of the comment on Federal "invasion" of this field has assumed that the Federal tax is a benefit levy, it lacks the more generally recognized benefit aspects of State gasoline taxes. Its late development would seem to indicate that it is unrelated to or only remotely connected with Federal highway aid programs. Rather, it was adopted as part of the expanding Federal excise-tax structure. Absence of exemptions for gasoline for nonhighway purposes further indicates that the Federal levy is similar to most other excise taxes. Revenues are not earmarked in the Federal Treasury for highway purposes as is characteristic of State gasoline taxes. Changes in the Federal tax have paralleled other changes in the excise-tax fields. Survey of the development of Federal excises on motor vehicles and supplies would seem to indicate that the Federal gasoline tax largely lacks the benefit characteristics of State gasoline taxation. The Eastman report on public aids to transportation[43] briefly sum-

[39] Cited by Finla G. Crawford, Motor Fuel Taxation in the United States, published by author, Syracuse, 1939, p. 14.
[40] State Government, vol. 6:7, July 1933, p. 3.
[41] Thirteenth Annual Report of North American Gasoline Tax Conference, 1938, p. 66.
[42] Crawford, op. cit., p. 15.
[43] Federal Coordinator of Transportation, Public Aids to Transportation, vol. IV, p. 54.

marizes this development. In 1914 the House Ways and Means Committee recommended a Federal tax on gasoline, and in 1915 President Wilson made a similar proposal. Neither suggestion was accepted. Both these proposals, the Eastman report emphasizes, were made before Federal appropriations for highways had reached significant proportions. Although the first excise tax on the sale of motor vehicles (October 3, 1917) came shortly after the Federal Highway Act of 1916, the tax was "patently an emergency revenue measure, and with the disappearance of the emergency the taxes were discontinued as rapidly as possible." It is to be noted that Federal aid for highways continued after the miscellaneous excise taxes were eliminated in 1928.

Reenactment of the old Federal excises in 1932, and the addition of new ones such as the gasoline tax, also resulted from an emergency. It has been pointed out that in the face of declining revenues, resulting from the depression, the United States Treasury Department recommended enactment of a number of excise taxes affecting the motoring public. A Federal gasoline tax was somewhat reluctantly enacted by Congress for 1 year only, but later it was renewed. Motor vehicles and the supplies they use, along with cosmetics, checks, and other evidences of what were looked upon as suitable sources for excise taxation, were taxed in the same manner. The Eastman report concluded as follows:

> Those who pay the latter taxes do so without receiving the benefits of the direct Federal provision of facilities for them to use. While it is true that the passage of the motor excises was made easier by the Federal expenditures on roads, it cannot be assumed that they would not have been imposed had there been no such expenditures.
>
> It is concluded, therefore, that these taxes should be treated as they are on the books of the Government, as one of a variety of excise taxes whose yield is not earmarked in any way and whose identity is lost along with that of other current revenues * * *. Congress has looked to motor-vehicle users for the support of the general functions of government.[44]

Charles Dearing points out that if the Federal Government were to conceive of its gasoline tax as a benefit tax, a circular process would be developed. Under this conception it would be logical to distribute revenue to the States on the basis of origin. Any other basis of distribution—for example, some special need—would constitute a tax-equalization program.[45] User charges, based on services rendered, would appear to be inappropriate for tax-equalization purposes. Mr. Dearing concludes that the direct and clear-cut way to preserve a sharp line of distinction between appropriate spheres of the Federal and State governments is to leave the States exclusive jurisdiction of special motor-vehicle charges. Federal participation would therefore be limited to such expenditures as can be justified in the general interest.

(3) *State tax a benefit tax.*—The development of State gasoline taxes in the United States has been based largely on benefits received by highway users. From its very beginning in Oregon in 1919, the gasoline tax has been closely associated with the development of modern State highways. State taxes on motor fuel are usually earmarked for highway purposes. Organizations representing the petroleum industry, the highway users, and numerous other groups have con-

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[44] Ibid.
[45] Charles Dearing, American Highway Policy, The Brookings Institution, Washington, 1942, p. 175.

sistently opposed so-called diversion of gasoline-tax revenues for other than highway purposes. To avoid taxing consumers of gasoline who are not benefited directly by highways, most nonhighway consumption of gasoline has been exempted from taxation or taxes paid thereon refunded.. And in order to make all consumption of motor fuel on highways taxable, States recently have developed fuel taxes on diesel oil. To smooth out irregularities in the application of the benefit principle, complicated schemes of licensing automobiles have been evolved by the States.

Thus part of the conflict between the State and Federal Government concerning gasoline taxes appears to be a conflict in theories, as well as a conflict in burdens and administration. The present Federal tax is most properly defended on the same principle as other excises, whereas the State taxes are justified on the basis of benefits received by highway users.

(c) *Reasons for rate variations among States.*

One suggested solution of intergovernmental gasoline-tax problems is substitution of a uniform Federal gasoline tax partly distributed to the States on some logical basis. This suggestion encounters wide variations in State taxation and raises questions concerning the reasons for such variations.

The gasoline tax plays a different role from State to State, depending on the extent to which the State tax system has been diversified, the extent of economic development, the character of the highway problem, and the degree to which the State has centralized its highway functions, borrowed to complete its highway program, and developed an integrated system of benefit taxation for highway purposes. Pressure for property-tax relief has also been involved.

States' policies with regard to gasoline taxes are intimately related to those adopted with regard to automobile license fees. A study by the Public Roads Administration[46] shows that 25 States, in 1938, collected less from motor-vehicle imposts than in the peak years of the late twenties. This was due partly to substitution of motor-fuel for motor-vehicle-license taxation. Some States substituted increased motor-fuel taxes for the property tax on motor vehicles. For example, Wisconsin, in 1931, raised its gasoline tax from 2 to 4 cents per gallon, repealed its property tax on motor vehicles, and distributed part of its motor-tax revenues to municipalities to compensate them for the loss of part of their tax base. Relationships among gasoline taxes, motor-vehicle licenses, and property taxes differ substantially from State to State.

Another reason for different tax rates on gasoline is that the financing of the highway function is in varying stages of centralization in different States. Centralization of the highway function has frequently been attended by increases in gasoline tax rates. For instance, North Carolina, in 1931, assumed complete responsibility for maintenance of all State and local highways outside of municipalities. In order to finance this transfer, the State gasoline tax was raised from 5 to 6 cents per gallon. Other State governments—especially Pennsylvania, Louisiana, Virginia, West Virginia, Minnesota, and Cali-

[46] R. H. Paddock, "Significant Trends in Motor Vehicle Registrations and Receipts," Public Roads, 20:8, October, 1939, p. 169.

fornia—have also assumed considerable highway mileage formerly financed by local governmental units from sources other than highway-user taxes. Likewise, the transfer of township and other local roads to counties has occurred in some States. Since 1930, Indiana, Iowa, and Oklahoma have adopted the county-unit system of rural highways in preference to the township system. In almost every case the highway-user taxes have been affected by these functional shifts.

In analyzing the shift in highway responsibility in North Carolina, and the accompanying increase in the gasoline tax, the Eastman study concluded:

> North Carolina acted on the hypothesis that the use of public roads has come to be so completely a use by automobile vehicles that the entire cost of maintenance * * * should be borne by automotive vehicles and not by a tax on property.[47]

Variations in highway-finance problems from one part of the country to another also account for differences in State gasoline taxes. Some of the factors which explain peculiarities of individual States are: Extent and character of industrialization and urbanization, density of population, character of industry and agriculture, topography and climate, availability of road-building materials, and the general financial well-being of the State. Variations are also justified on the basis of the extent to which principal construction programs have been completed. This point is of vital importance where States have borrowed heavily to construct principal highways.

The ability of State tax systems to yield sufficient revenues for modern highways also accounts for differences in gasoline-tax rates. In large areas of the agricultural South, wealth and incomes for a considerable segment of the population are low. Hence it takes a much greater effort on their part to provide highway funds equivalent to those available in States where resources are more plentiful. This is perhaps the most important reason why States with highest tax rates are concentrated in the South. The nine States with tax rates of 6 cents or more are all located in this area. These taxes are also a means of reaching out-of-State highway users.

Earmarking of gasoline taxes for debt retirement also accounts for some variations in gasoline tax rates. In many States the current tax rate, for all practical purposes, is frozen into the law. The first claim on the revenue is an amount sufficient to service bonded indebtedness. In 1940, 38 States used part of their gasoline taxes for servicing indebtedness. One-fourth of the States used over 20 percent of their motor-fuel taxes for this purpose.[48]

(*d*) *Results of dual administration and compliance.*

Inasmuch as several proposals for fiscal coordination are aimed principally at the elimination of dual administration and compliance costs, and of jurisdictional difficulties in State administration, an examination of the administrative aspects of the motor-fuel-tax system is in order.

Because administrative costs on both the Federal and State levels are very reasonable, the duplication in tax administration is not as serious a matter as might be supposed. Owing to the fact that the Federal tax is levied on the manufacture and importation of gasoline,

[47] Federal Coordinator of Transportation, Public Aids to Transportation, vol. IV, p. 29.
[48] Calculated from Public Roads Administration, Disposition of State Motor-Fuel Tax Receipts, 1940 (table G-3).

collections are made from only 1,100 concerns. On the basis of total gasoline tax collections of $226.2 million in the fiscal year ending in 1940, the Federal Government collects an average of $215 thousand per taxpayer. But this average is hardly representative. In 1937, 20 major companies manufactured 84 percent of the gasoline produced in this country.[49] Other reasons for low Federal collection costs are that (1) exemptions are relatively minor; (2) the problem of bootlegging is almost nonexistent. Although the Treasury has no cost figures on gasoline-tax administration, it is said that this tax, along with tobacco taxes, is among the cheapest to collect of any of the major taxes administered by the Bureau of Internal Revenue. What information is available tends to indicate that very little gasoline completely escapes from Federal taxation.

Analysis of State administrative costs is difficult. Cheap administration may actually be expensive in terms of gasoline that escapes taxation. Also, with some exceptions, the cost of administering a 2-cent tax is about as great as the cost of administering a 7-cent tax. Administrative costs do not increase proportionately with increases in the rates of the tax. To the extent that the higher tax rate encourages more bootlegging, some increased costs might be expected.

Few States keep cost-accounting records for State tax administration. Often, the gasoline tax is administered in connection with other taxes, making it difficult to isolate the cost attributable to the one tax. Administrative tasks vary greatly from one State to another. Gasoline used for nonhighway purposes in some States is exempt from taxation, while in others the tax may be refunded, and in still others there are no exemptions. In some States, the cost of maintaining ports of entry has been considered as a cost of administering State gasoline taxes. Studies of the Twentieth Century Fund[50] showed the average cost of administering State gasoline taxes from 1925 to 1933, as follows:

Cost of administering State gasoline taxes

Year	Percent of gross revenue	Number of States reporting	Year	Percent of gross revenue	Number of States reporting
1925	0.25	21	1930	0.31	39
1926	.27	25	1931	.45	43
1927	.34	32	1932	.65	41
1928	.33	33	1933	.53	47
1929	.25	36			

The average for the period 1925–33 was about 0.37 percent. In 1933 the cost varied, for particular States, from 0.04 percent of gross revenue in North Carolina to 3.3 percent in Arkansas. If the above national average held true in 1940, the total cost of gasoline-tax administration in all the 48 States amounted to only approximately three or four million dollars.

Using data gathered directly and data secured from State official records and published in Public Roads, James W. Martin presents gasoline tax administration costs in recent years for the individual

[49] Temporary National Economic Committee, Hearings, pt. 14, Petroleum Industry, p. 7103.
[50] Twentieth Century Fund, Studies in Current Tax Problems, New York, 1937, p. 118. These data are quite consistent with the more recent figures gathered by James W. Martin, a summary of which was presented in ch. IV, above.

States. The data show a range in average costs from 0.7 percent during 1935 to 1938 to 0.5 percent in 1940. The range among States at the latter date was from 0.1 percent in several States to 1.1 percent in Minnesota. The figures indicate that a heavy factor in administrative costs is that involved in allowing exemptions and refunds, perhaps not strictly a tax administration function.[51] In spite of the limitation of the data, it is apparent that the savings in administrative costs that coordination might be expected to effect at the State level are relatively slight.

Comparison between Federal and State administrative costs is even more difficult, since the costs of each arise from different causes, and collections are from different sources. The State of Kentucky has cost figures that are, perhaps, more nearly comparable to the Federal figures than those of any other State; it makes no exemptions or refunds of taxes where gasoline is used for nonhighway purposes. Professor Martin found that costs of administration in Kentucky amounted to 0.12 percent. Before introduction of cost accounting records, the Kentucky Tax Commission had estimated administrative expenses at 0.50 percent, or more than four times as much as was shown with proper records.

The inconvenience and the added cost of duplicate tax compliance is not a significant problem. The commodity is uniform and the tax is definite, and is based on quantity rather than price of product. It is a simple matter to calculate tax liability and few additional records are necessitated by the tax.

The two most serious gasoline-tax problems on the State level are: (1) The interstate shipment of gasoline, which sometimes results in tax avoidance of one kind or another, and (2) the intrastate problem of exemptions or refunds on gasoline used for nonhighway purposes.

Regarding the first, States are aware of the bootlegging problem and have made real headway in stamping it out. One type of bootlegging occurs when a distributor operating in several States with differing gasoline tax rates pays the State tax which is lowest, and then proceeds to sell the gasoline in the State which has the higher tax. Thus a Missouri distributor might willingly pay the 2-cent Missouri tax on gasoline which could be smuggled into Arkansas, where the tax rate is 6 cents per gallon. The other type of bootlegging occurs when gasoline escapes from taxation in all States.

Through cooperation, the States are making an effective effort to cope with the interstate bootlegging problem. At one time, organized evasion on the part of a small number of the less reliable gasoline dealers was prevalent on the waterways that spread through the densely populated areas of New Jersey, New York, and New England.[52]

Interstate reporting in the 13 States in the northeastern region is now well organized and developed. A uniform report form was devised through the cooperative efforts of State motor-fuel-tax administrators working closely with gasoline tax distributors.

Lepawsky describes the operation of this system as follows:

> The system works as an automatic check upon the interstate movement of gasoline in the following manner: Company A of New Jersey reports on the uniform report blank that it is selling gasoline to Company B in New York State, but Company A is nevertheless charged with the tax by New Jersey and will

[51] Monograph prepared for this study: James W. Martin, Cost and Efficiency of Tax Administration.
[52] Albert Lepawsky, "Examples of Interstate Administrative Cooperation in the Tax Field," Tax Relations Among Governmental Units, Tax Policy League, 1938, p. 65.

receive no credit or deduction or refund from New Jersey for the export unless the following steps are taken:

1. Company A fills out the New Jersey export form in duplicate and sends it to the New Jersey Motor Fuel Division the day on which the sale is made.
2. New Jersey sends one copy of this export report to New York's motor-fuel-tax bureau.
3. The company fills out the New York import form in duplicate and sends it to New York's motor-fuel-tax bureau within 24 hours.
4. New York sends a copy of the import form to New Jersey.
5. New Jersey and New York compare their copies of both the import and export returns and find that they match.
6. New York reports to New Jersey that the cargo as described in the report has entered the State.[53]

Similar procedures have been worked out in other parts of the country and appear to be operating successfully. The United States Department of the Interior has helped by providing States with reports showing the detail of every movement of motor fuel carried from the producing State by ship to any other State.

Regarding the second main problem of State gasoline taxation, that of exemptions or refunds of taxes when gasoline is used for nonhighway purposes, little need be said here since the problem is essentially of an intrastate nature. Exemptions or refunds are allowed by over two-thirds of the States. Exemptions are not practiced generally in the South, where gasoline taxes are the highest in this country.

While the exemption question is mainly an intrastate problem, it has some implications in Federal-State relations. If the gasoline tax were federalized, procedures probably would have to be provided for tax refunds on nonhighway gasoline. That this would add greatly to the cost of administration is certain. Furthermore, it is probable that the exemption would be applied to both the Federal and State share of the gasoline tax.

(*e*) *Elimination of conflicting taxation in the motor-fuel-tax field.*

Proposals for treatment of conflicting taxation in the motor-fuel-tax field may be roughly grouped into four major categories:

(1) Uniform Federal gasoline tax with State sharing;
(2) Federal administration of both taxes with States retaining their present rates;
(3) Continuation as at present;
(4) Eventual withdrawal of the Federal Government from the field.

The first suggestion is that the Federal Government impose a gasoline tax and that the States withdraw from the field in return for a share of the proceeds. Advantages claimed for the proposal are that it would simplify administration, solve the bootleg problem, and eliminate the interstate trade barriers growing out of variations in State tax rates. The question is whether such a proposal would not also raise more troublesome problems than those it would cure.

If such a plan were placed in operation, it seems likely that the States would reject any formula for distributing the proceeds that did not correlate fairly close with present gasoline consumption in each State. Complicated allocation formulas such as that proposed in the Graves-Edmonds plan of 1934 [54] (according to population, motor registrations, and improved highway mileage) would be rejected as inapplicable to a

[53] Lepawsky, op. cit., pp. 66-67.
[54] See ch. I.

benefit tax. Allocation on the basis of motor registrations or on gasoline consumption might be used. It is obvious that either formula would greatly reduce the receipts of the poorer States and considerably increase the already large receipts of the wealthier and more thickly populated States. Furthermore, the States would consider any allocation formula as in the realm of politics.

Centralization of the tax in the Federal Government would also raise other new problems. For instance, (1) a legal problem would be encountered where present high State tax rates are frozen into existing laws by earmarking of revenue for servicing highway indebtedness. Such earmarking in many cases approaches the status of a contractual arrangement. (2) Unless all the States consented to the elimination of all tax exemptions or refunds, a system of administering refunds or exemptions would have to be set up by the Federal Government in order to avoid taxing gasoline consumed for nonhighway purposes. If exemptions were continued, it is probable that there would be a demand for their extension to the tax retained by the Federal Government. (3) Additional information would have to be collected by the Federal Government on consumption of gasoline in each of the States. If strictly interpreted, this requirement would largely nullify the advantages of simplicity claimed for Federal gasoline-tax administration. (4) If formulas which pay no attention to needs of the States were used, some States might have excess revenues, and spend them extravagantly, while others might be forced to starve the services now dependent on gasoline-tax revenues. (5) Substitution of a uniform tax for the present State rates would take no account of the fact that the present rate in each State is intimately related to the motor-vehicle registration tax, and to the other highway-user taxes as well as to the general property tax. (6) Substitution of a uniform gasoline tax would take no account of the fact that the States use the gasoline tax only as one part of their scheme of apportioning highway costs to highway users. Motor-vehicle registration taxes measure relative burdens as between classes of users, leaving the gasoline tax to measure road occupancy. A uniform Federal levy would not heed these adjustments.

The conclusion is that so long as present responsibilities for highways remain what they are, a Federal uniform gasoline tax shared with States would create many more problems than it would solve.

A second suggestion for resolving intergovernmental gasoline-tax problems calls for Federal administration of both taxes, the rate levied by each Government to be left to its own discretion. In other words, each would continue to levy present tax rates with the Federal Government collecting both taxes. This would make the State taxes supplemental to the Federal. A system of this sort is found in Argentina where the States are permitted to levy a surtax on the Federal gasoline tax. Advantages claimed are that it would reduce costs of tax administration, would simplify tax compliance, and would freeze out the bootlegger.

Perhaps the best talking point for this method of centralized administration is that State receipts from the tax would remain substantially unchanged. As a consequence, previously established relationships between gasoline taxes and motor-vehicle-registration taxes, and other State and local taxes, would continue as before. Present tax rates, frozen into existing State laws by reason of indebtedness or other factors, would remain undisturbed. No changes in methods of financing highways in one State as compared with another would be necessary. Variation among the States in highway needs and in taxable resources would be recognized. And lastly, both Governments could continue to fix the rate of their own taxes in the light of their own revenue needs.

But just as a uniform Federal gasoline tax would raise new problems, so, too, State additions to Federal taxes would raise several of the same problems as well as create others.

For one thing, it seems unlikely that total administrative costs could be cut by central administration of both taxes. Federal administrative costs would be greatly increased because of additional complications in collection procedure. The Federal Government could no longer collect from only 1,100 manufacturers and importers. Instead, it would have to determine, as the States now do, the final destination of gasoline in order to apply the proper State tax rate and allocate collections therefrom. In order to do this it would be necessary to obtain information from distributors, and in some cases from gasoline retailers. Thus, an obvious advantage of centralized collection would have been lost. Manufacturers and importers might be required to provide information on final destination of gasoline for tax purposes. However, such information could be provided only by a great deal more bookkeeping and extra expense on their part. This expense and trouble would not be offset by compensating advantages either to taxpayers or to the Government.

Decentralized administrative procedure would also have to be installed by the Federal Government to administer effectively exemptions and refunds on gasoline used for nonhighway purposes. Such procedure would be necessary unless the States continued to perform this function. If they so continued, then a considerable part of State administrative costs would still be necessary.

The bootlegging problem would be only partly solved by Federal administration of both taxes. True, gasoline would not go scot free from State gasoline taxes. But Federal collection alone would not solve the interstate conflict resulting from varying State tax rates. It would still be possible for unscrupulous tradesmen to transport taxed gasoline from low-tax States to high-tax States without paying the tax differential. Thus Federal collection of both taxes would not avoid tax-enforcement problems now faced by States. The States would still have to provide enforcement machinery or the Federal Government would have to establish similar machinery.

It is apparent that Federal administration of both taxes would add greatly to the present administrative costs of the Federal Government, while at the same time increasing the expense and trouble of tax compliance. It would neither eliminate the cost of administering tax refunds or tax exemptions, nor eliminate the bootleg problem, both of which now constitute the major administrative problems of State administration.

A third alternative is to continue the present arrangement with States levying, collecting, and enforcing their own gasoline taxes and the Federal Government doing likewise. In all probability this is the alternative which will be followed during the present emergency. It is unlikely that either the Federal Government or the States would consent to surrender this source now when needs for revenue are so urgent.

Separate administration and levy leave the States free to handle intrastate problems, including the special treatment of motor fuel consumed off the highways, a task which the Federal Government could not easily avoid if the tax were centralized. This does not interfere with integration of gasoline taxes with other State highway user revenue; it does not prevent development of equitable road-use taxes, motor-vehicle-registration taxes, and methods of taxing trucks.

The Federal Government, likewise, is free to continue levying excise taxes on gasoline. It avoids the perplexing task of handling motor-fuel exemptions and refunds, and of controlling bootlegging. It is free to manipulate its rate in terms of revenue needs. Simplicity and economy of administration, advantageous both to the Government and to the taxpayer, continue.

The principal disadvantage to this arrangement is the duplication of levies, with resulting higher taxes on gasoline. While no evidence is available to indicate that the combined special taxes on gasoline have restricted consumption, it is alleged that the Federal levy has hampered needed efforts in the direction of general-property-tax relief, a problem of growing acuteness in municipalities. Cities, in particular, have complained that property-tax relief for them, as a result of distribution of motor-fuel revenues, has been conspicuously meager.

The fourth remedy involves eventual withdrawal of the Federal Government from the gasoline-tax field. This is the proposal most strongly supported by the States, by the petroleum industry, by highway organizations, and by many members of Congress.

Advantages of Federal withdrawal from the gasoline-tax field over other proposals for tax coordination are that it would not create new and extremely difficult administrative problems. On the one hand the States would retain primary responsibility for highway functions, and likewise of highway revenues. The States would continue with the complex task of integrating gasoline taxation with other motor-fuel taxes, and with other highway-user taxes. On the other hand, the Federal Government would be relieved of the huge administrative task involved in adjusting a centralized tax on motor fuel to use for highway purposes. States would be permitted to continue their policies as to refunds and exemptions. Present as well as future commitments of the States on uses of gasoline-tax revenue would remain undisturbed. The minor fiscal importance of the tax in the Federal tax picture would make the solution possible without greatly disrupting Federal finances.

There are two principal disadvantages to this remedy. First is the loss in tax revenue to the Federal Government, a loss which the Federal Government would be reluctant to take at this time, but which might be less objectionable later. The Federal Government has always considered this tax as merely one of the selective excises. The loss could be replaced by utilization of other tax sources, perhaps to the improvement of the incidence of the Federal revenue system.

The second disadvantage of this solution is that interstate difficulties would remain unsolved. Federal abandonment of the gasoline tax would result only in eliminating the conflicts growing out of a dual tax burden on gasoline. It would do nothing to eliminate the bootlegging problem.

Although the States are gradually solving their administrative problems in the motor fuel tax field, the Federal Government, if it wishes to be helpful in this matter, might, through its authority to regulate interstate commerce, obtain and supply the States with additional information concerning interstate gasoline movements.

Looking to the future, it is suggested that Federal and State separation of sources in the motor fuel tax field might take the form of exclusive Federal taxation of fuel used in aviation and exclusive State taxation of other motor fuel.[55] Two-thirds of the States now exempt aviation fuel from State taxation, and the remainder either have special aviation tax provisions or do not receive much revenue from this source. Potentially, however, the field is promising. It is appropriate for the Federal Government, since aviation is essentially an interstate enterprise, and the licensing of airplanes and the regulation of air travel are already national. If the Federal Government so desired, it might use the yield of the aviation fuel tax to finance the construction and maintenance of free public airports, the laying out and maintenance of beacon systems, the provision for weather information, and pilot licensing.

In conclusion, the coordination device recommended for the motor-fuel tax is separation of sources, the Federal Government to withdraw from the field as rapidly as financial exigencies will permit.

2. MOTOR-VEHICLE-LICENSE TAXES

The motor-vehicle-license tax, as a member of the overlapping Federal-State tax family, is quite similar in most respects to the motor-fuel tax. The former, like the latter, was first and predominantly developed by the States; in fact, the Federal Government entered the field with its automobile-use tax only in 1941. If there are good reasons why the Federal Government should withdraw from the motor-fuel-tax field there are even better reasons why it should withdraw from the motor-vehicle-license field.

The motor-vehicle-license tax as used by the States, is part of a program of financing highways on the principle of benefits received. In addition, it is closely related to the policing of automobile traffic, a State and local function. State administration has been of uneven quality and rather expensive. But the expense is justified, at least in part, by the dual functions (revenue and policing) performed in licensing. At all events, the Federal Government has few if any advantages, as compared with the States, in administering automobile-use taxes. And dual administration appears to be utterly wasteful.

Federal collection and State sharing in the motor-vehicle-tax field has never been seriously proposed. In addition to other difficulties in such a program, the fact that differences in State laws are woven into the texture of State property taxation is a formidable obstacle and objection to uniformity in this field. When motor vehicles first were developed on a commercial scale, practically all States were employing the general property tax as the principal source of State

[55] This recommendation presupposes that aviation gasoline will remain a product separate from motor-vehicle gasoline. If the two products were to become interchangeable, separation of sources might not be administratively practicable.

and local revenue. The States, accordingly, taxed motor vehicles under the general property tax like other personal property. As the number of vehicles multiplied, difficult assessment and collection problems led many States to modify or entirely abandon the general property tax on motor vehicles. At the beginning of 1942 there were only 16 States in which the original status of motor vehicles under the general property tax had not been altered materially. State registration fees had been added to supplement the general property tax. In 7 other States and the District of Columbia, the general property tax had been retained but had been modified to the extent of requiring payment as a prerequisite to State registration. Eight States had replaced the general property tax with special property taxes requiring payment as a condition for State registration. In 18 States, motor vehicles were not ordinarily subject to either general or special property taxes. However, in most cases, the registration fee had been raised to compensate for the exemption. The usual rule, with some exceptions, was that the exemption from property taxes was contingent upon payment of the State registration tax.[56]

States have graduated their registration taxes according to more or less rough measures of destructiveness of vehicles to highways. While this has applied to passenger cars, as well as to trucks and busses, it is for the latter that it has become most important. As of 1937, there were 11 different bases on which graduated passenger-car-registration taxes in the several States were levied; the number for trucks was 15, and for trailers, 13. The trend seems to favor net weight as the basis of classification.

Thus the motor-vehicle tax plays such a variety of roles in different States that an attempt to standardize this levy would encounter prohibitive difficulties.

Although the Federal Government has the right-of-way in taxation during the war period, it is exceedingly doubtful whether Federal invasion of a field long occupied by the States and their subdivisions and one well adapted to administration at the State and local level accomplishes any useful purpose. Federal administration, according to numerous unofficial reports, has been inadequate as to enforcement. Moreover, the Federal Government already imposes manufacturers' excises on motor vehicles and motor fuel.

The Federal motor-vehicle-use tax leaves much to be desired from the point of view of equity as well. Available information on the estimated distribution of ownership of family automobiles by family income groups in 1935–36 indicates that almost 52 percent of the passenger cars were then owned by families with annual income of not more than $1,500.[57] A comparison of the $5 automobile-use tax with average automobile registration fees in the States reveals that the $5 Federal-use tax is equal to 27 percent of the average State registration fee in one State and 195 percent in another.

Available information on the estimated market value of passenger cars in use on December 31, 1939, indicate that the average value of of cars was then $238 and that the $5 use tax was equivalent to 2.1 percent of the average value of all passenger cars.[58] More than half of the cars in use on December 31, 1939, had a value of less than $173.

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[56] Thus a large decrease in registrations, owing to war shortages, would, barring administration difficulties, give municipalities increased tax bases, leaving the States to hold the bag.

[57] H. Doc. No. 272, Toll Roads and Free Roads, 76th Cong., 1st sess., p. 15.

[58] Data supplied by Automobile Manufacturers Association, Statistical Department, Detroit.

Data on the distribution of motor vehicles by community-size classes, indicate that more than half of the burden of the $5 use tax falls on communities with 10,000 persons or less and that 31 percent of the burden falls on those living on farms and in unincorporated areas.[59]

During the war period, because of the shortage of rubber, State and Federal revenues from the taxation of motor vehicles can be expected to decline rapidly. What latitude remains in the tax rate should be left for emergency exploitation by the States. This and the above considerations indicate the desirability of immediately repealing the Federal automobile use tax.

If the Federal tax is retained, efforts should be continued to secure more collaboration in administration. The new Federal tax seemed to furnish the ideal opportunity for Federal-State collaboration in administration. However, the very impressive difficulties encountered by the Bureau of Internal Revenue when such a program was contemplated, demonstrate the fact that such collaboration cannot be improvised successfully, and requires long planning and careful arrangements as to detail. Among the difficulties encountered were different State collection dates, possible unwillingness of States to cooperate, absence of State and Federal authority for such arrangement without specific action by Congress and by the respective State legislatures, decentralized State administration (in some cases), problem of bonding State officials, and State political opposition. It seems probable that the Federal Government cannot rely on State administration in a case of this sort without more adequate means of holding the States accountable and without being in a position to administer the tax directly if the States fail to observe standards. It is situations of this kind that support the recommendation for a Federal-State Fiscal Authority.

The present arrangement for administering the automobile-use tax virtually amounts to voluntary payment, collected by the Post Office Department. (This statement, without qualification, no longer holds for that part of the country in which the purchaser of gasoline is rationed; privileges as to rationing are conditioned, though not very effectively, upon evidence of use-tax payment.)[60] Even within the limitations of existing institutions, it would seem that some arrangement whereby the States would require a receipt for the payment of the Federal tax as a condition of issuing automobile licenses, should be quite possible, and a definitely desirable arrangement.

Another aspect of intergovernmental relations in the field of motor-vehicle taxation is the excessive taxation of trucks engaged in interstate commerce. Some discussion of this problem will be found in the section on trade barriers. The problem arises from the excessive number of levies imposed upon trucks and busses engaged in interstate commerce. It might be possible to solve this difficulty by a system of Federal taxation with distribution to the States which stay out of this field. But this program involves many complications and difficulties of its own. Substantial progress toward the elimination of impediments to commerce is now being made by means of reciprocity legislation and agreements. It is recommended that efforts be

[59] Data supplied by U. S. Public Roads Administration.
[60] Written in the summer of 1942.

exerted to expand the present trend and that a Federal-State agency be created to facilitate the movement.

The motor-vehicle license and use-tax field is one which forms a lucrative and badly needed source of revenue for the States and one which they are exploiting or might exploit quite adequately and satisfactorily. Accordingly, separation of sources is recommended, the tax source to be left for the States.

D. Retail Sales Taxes [61]

1. INTEGRATING STATE TAXES WITH POTENTIAL FEDERAL TAX

The retail sales tax is not an overlapping tax at present but there is a possibility that it may become such by virtue of Federal entrance into the field. The possibility of this development is sufficiently real to warrant a lively interest in coordination devices as applied to this field of taxation.

One coordination device commonly advocated, mostly by sales-tax proponents, is Federal collection and State sharing. This meets with the objection that it would, in effect, universalize, by Federal compulsion, States' reliance upon a regressive tax source. Less than half the States employ a general sales tax, and it would involve a heavy commitment in favor of this form of taxation to force the other States to incorporate the tax in their revenue systems. Students of taxation have been quite critical of the development of State sales taxes even to the present level, both because such taxes are thought to aggravate a chronic peacetime shortage of purchasing power and because these levies are reminiscent of the oppressive tax systems of the nineteenth century with their heavy duties on salt, soap, candles, and other necessities. Unless the sentiment for sales taxation becomes much stronger and much more universal than at present, Federal collection and State sharing would be unacceptable. Additional objections to a sharing scheme are the usual difficulties of apportionment, and the inadaptability of such a scheme to the varying revenue needs of the States.

If in the course of the present emergency the Federal Government should deem it necessary to enter the retail-sales-tax field, this would add an additional overlapping tax to the growing list. While the development of further overlapping should be regarded with skepticism, the Federal emergency is so urgent, and the sales tax such a powerful fiscal instrument, that the duplication can hardly be regarded as a conclusive objection to a Federal retail sales tax. This is to express no judgment concerning the advisability of this measure on other grounds.

If a Federal retail sales tax is adopted as a war measure, this should be the occasion of a concerted effort to achieve more coordination between Federal and State taxes. The coordination device appropriate for the retail-sales-tax field is administrative collaboration and uniformity (so far as possible) of legislation and regulation, leading toward joint administration.

In the interest both of revenue and of uniformity, the Federal tax should have a broad base and few exemptions. An ideal arrange-

[61] Based partly upon monographs prepared for this study: Neil H. Jacoby, Federal-State-Local Fiscal Relations in the Field of Sales Taxation; Loren D. Melton, Federal and State Retail Sales Taxation.

ment, from the standpoint of Federal-State relations, would be one which would permit the Bureau of Internal Revenue to work out such cooperative arrangements with each sales-tax State as seemed feasible. Statutory authorization for such flexibility in relations should be granted. The Bureau should take cognizance of the differences in State laws and administrative practices, and suitable arrangements should be made whereby each would be enabled to gain the most from the facilities and personnel of the other. Conferences with State administrators respecting rules and regulations would be of considerable aid in obtaining the benefits of State experience and in securing maximum uniformity of application. Facilities of State and municipal sales-tax administrators could be utilized to obtain a list of vendors of tangible personal property. Mutual exchange of information in such matters as the opening of new businesses, discontinuance of old businesses, and changes in ownership would prove helpful in reducing tax loss. The development of a joint auditing program or the exchange of Federal and State audits would operate to the benefit of both the Federal and State authorities in that each would realize more extensive field-audit control over taxpayers without corresponding increases in audit costs. The pooling of scarce sorting and tabulating equipment wherever feasible also would avoid duplication and reduce costs. If practicable, the development of joint return forms would reduce administrative and compliance costs. Information on the issuance and cancelation of licenses (if used) might be regularly interchanged, as might facts respecting law violators and legal action against delinquent vendors.

Complete integration of administration in the Federal Government would have its advantages, but the States might reasonably object to such an arrangement on many grounds, among them that the Federal tax would be, presumably, an emergency measure only. A more flexible arrangement, with State collection of the Federal tax in some States and Federal collection of the State tax in others, would appear more feasible, but might prove cumbersome for the Bureau of Internal Revenue. It is quite possible that the more limited type of unification of efforts and facilities would prove most acceptable. Nevertheless, it would seem desirable that an opportunity be left open for experimentation either in State collection of the Federal tax, Federal collection of the State tax, or even the collection of both taxes by a joint administrative agency.

2. EXISTING PROBLEMS OF OVERLAPPING

Thus far the discussion has been concerned with the development of overlapping taxation which would result from Federal entrance into the retail-sales-tax field. But some overlapping is already present. In addition to that involved in the selective sales taxes, discussed elsewhere, the general retail sales taxes and use taxes of nearly all the 22 sales-tax States, apply to most commodities subject to selective State or Federal excises.

Overlapping in sales taxation is not necessarily an evil. Probably the bulk of it is harmless. The charge is unfounded that State retail sales taxes are "unfair" or "discriminatory," or lay a "tax on a tax" if they do not exempt commodities subject to Federal excises or to selective State sales taxes. All cost-raising taxes applicable to a given commodity must be considered together in judging the equity of taxation—the mere fact that there are several separate tax elements in the retail price of gasoline, for example, does not per se create inequity. Thus, the theory of gasoline taxation in most States is to exact a benefit payment from motor-vehicle owners for use of State highways, whereas the general retail sales tax is presumed to lay a burden proportionate to expenditure on tangibles. It violates both principles (each of which may, of course, be erroneous) to exempt gasoline from a retail sales tax merely because it is subject to a separate selective tax. So it is with liquor taxes. Equity in taxation does not demand that a State exempt liquor from its general retail sales tax, just because the Federal Government and the State may have singled liquor out for selective taxation.

The present rule in Federal income-tax practice, under which certain sales taxes are deductible expenses for the individual taxpayer while others (where the legal incidence is on the retailer) are not, seems quite undesirable. The fact that these taxes are based on consumption and are not outlays involved in the creation of income supports the view that they should be nondeductible. This view is also supported by the difficulty of reporting this deduction accurately and of checking the report for reliability. However, if the privilege of deductibility is retained, it should be general and not conditioned upon a technicality in the tax law.

3. JURISDICTIONAL PROBLEMS IN TAXING INTERSTATE SALES

(a) *Introduction.*

The sales tax, at the State level, encounters administrative and jurisdictional difficulties involving coordination problems. The States are not allowed to tax what is clearly an interstate sale by an out-of-State vendor. Such taxation would be a clear case of violation of the implied immunity of interstate commerce from taxation. To be sure, States are allowed to tax goods from other States once they have come to rest in the taxing State. By means of compensating use or personal property taxes, this can be done so as to avoid discrimination in the application of sales taxes to purchases from domestic vendors. However, except as applied to conspicuous articles of purchase like automobiles (in which case registration provides the information required for enforcement), or where collected at the source, these devices are not very effective from the administrative standpoint.

There are two phases of the relation between the commerce clause and State powers to collect sales taxes, namely, power to tax property moving *out* of a State for consumption, and power to tax property moving *into* a State for consumption. With respect to the first phase, it is well settled that a State cannot tax either the sale of, or the occupation of selling, property which moves as a necessary part of the transaction, from the taxing State into another State. There has been much litigation because States have been zealous in attempting to prevent out-of-State vendors, selling property in competition with their own vendors, from enjoying competitive advantages. An out-of-State retailer maintaining no place of business in a sales-tax State, and soliciting business therein only by mail, telephone, or telegraph is, of course, outside the jurisdiction of the State and its sales tax cannot apply. Such a retailer can also send his salesmen or agents into a State and solicit an order subject to his confirmation outside the State, and the sales-tax State cannot subject to sales taxation the property moving into it pursuant to these orders. But the situation is now quite different in case the vendor has a place of business within the taxing State, so that it acquires jurisdiction over him.

(*b*) *Recent judicial history.*

Up to 1935 retailers in a sales-tax State were able to escape sales taxation on property delivered directly by them, from an out-of-State source, to a consumer in the taxing State. The first step taken by the United States Supreme Court to close this door of escape occurred in the Wiloil Corporation case,[62] when it was held that a retailer in a taxing State must be required under his contract of sale to obtain the property outside the State, and to make an interstate shipment in order to complete the sale, before the tax could be avoided. In theory, this decision materially lessened the scope for avoidance by taxing a retailer if he were free to make delivery from stocks within the taxing State. In practice, it was easy for vendors to make a formal contract with vendees calling for a tax-free interstate shipment to complete the sale. Consequently, in 1940, the Supreme Court plugged this gap in its notable decisions in the Berwind-White[63] and associated cases. At the present time, it appears that any sale involving the movement of goods to a consumer in a sales-tax State can be taxed if the vendor comes within the jurisdiction of that State by having an office or place of business there.

Even in cases where a seller to consumers in a sales-tax State takes orders only by traveling salesmen, mail, telephone, or telegraph, and maintains no office in the taxing State, the State may, in theory, destroy the competitive advantage he enjoys over local vendors who must pay the sales tax by laying a use tax. Theoretically, use taxes apply to every user or consumer of property subject to sales taxation on the retail sale of which a tax has not already been paid. If not collected from the retailer, the laws of most States require that the use tax shall be collected from the consumer. In practice, however, it has proved impracticable to make a complete collection of use taxes from consumers—the amounts of tax collectible are too minute per individual and the number of taxpayers too large to warrant close enforcement. Unless use taxes can be collected from retailers, they are likely to be evaded in large part.

The recent Supreme Court decision in the Sears, Roebuck case[64] permits a use-tax State to collect its use tax from the retailer, if the State has jurisdiction over him, even though the particular sales with respect to which the use tax is applied were technically made outside the use-tax State and the goods were shipped in interstate commerce in order to fill the order. Thus mail-order houses like Montgomery Ward & Co. or Sears, Roebuck & Co., maintaining retail stores in nearly all States, can be compelled to collect and pay use taxes with respect to their mail-order business with consumers in those States that have use taxes. For all practical purposes the limitations of the commerce clause are gone—the Supreme Court recognizes the right

[62] *Wiloil Corporation* v. *Pennsylvania* (294 U. S. 169 (1934)).
[63] *McGoldrick* v. *Berwind-White Coal Mining Co.* (309 U. S. 33 (1940)).
[64] *Nelson* v. *Sears, Roebuck & Co.* (312 U. S. 359 (1941)).

of States wherein goods are used or consumed to lay their sales or use taxes if they can only get their hands on the seller.

The upshot is that the only important class of retail sales now able to escape sales or use taxation in practice are those made by retailers who maintain no places of business in the taxing States and operate so that these States have no jurisdiction over them. Such mail-order houses as Spiegels, Chicago Mail Order House, National Bellas Hess Co., Simpson's, Fuller Brush Co. can sell tax-free in other States than those in which they are located, because the State of consumption cannot compel the seller to pay a sales tax or to collect from the consumer a use tax on these sales. This circumstance creates an unfair competitive situation, in that the two classes of mail-order houses are in substantial competition with each other, and one class escapes the significant costs of complying with use-tax laws.

(c) *Extent of tax escape through jurisdictional loopholes.*

It would be valuable to know what percentage of all retail business escapes State sales or use taxation as a result of jurisdictional limitations upon States' powers. While there is no accurate method of estimation, a first approximation may be obtained by adding up the annual sales of all of the principal retailing concerns known to engage in a strictly mail-order business from one location. The Census of Business for 1939 enumerated 434 mail-order houses whose total mail-order sales (excluding any sales made from retail stores) aggregated $537,413,000, or about 1.3 percent of all retail sales made in the United States during 1939. Since the mail-order sales of Sears, Roebuck & Co. and Montgomery Ward & Co. comprised about $375 millions, or 70 percent of this total, and these companies are subjected to State use taxes because of their local retailing operations, only the remaining $262 millions of sales, comprising 30 percent of the total would, in general, escape because of lack of State jurisdiction.[65] In addition, the census enumerated some 5,199 central offices or headquarters of direct selling and house-to-house selling concerns, whose total sales during 1939 amounted to $153,397,000. It seems likely that a substantial part of these sales was made by concerns employing salesmen to take orders only, the headquarters of the vendor and the shipment of goods being made from outside the State of consumption. If one arbitrarily assumes that one-half of such sales were of this type, then an additional $77 millions of sales eluded State taxing powers. Adding these sales to the $262 millions of nontaxable mail-order sales, there was a total gap of about $339 millions during 1939.[66]

One might therefore conclude that sales beyond the jurisdictional powers of States to collect sales or use taxes from vendors under current legal interpretations amount to something less than 1 percent of total national retail sales. This is too small an amount to be regarded as possessing much consequence from the point of view of revenue productivity. But it has much more than proportional significance

[65] Sears' total sales for the year ended January 29, 1940, amounted to $617,414,266, of which about 30 percent, or $185,221,000, were mail-order sales. Ward's total sales during the year ended January 31, 1940, were $474,882,032, of which about 40 percent, or $189,953,000, were mail-order sales. Hence these two leading national mail-order houses account for about $375,000,000, or 70 percent, of all mail-order sales.

[66] A majority of the mail-order and direct-sales concerns maintain headquarters in Chicago or New York City. Their sales to residents of the State of Illinois or city of New York would, of course, be subject to any sales or use taxes levied by these jurisdictions. However, any upward bias in the estimate resulting from failure to deduct these taxable sales is probably offset by mail-order or other nontaxable sales made occasionally by retailers classified by the census as conducting other types of operation.

in the competitive situation between retail vendors doing business in different ways.

Moreover, the preceding discussion has sought to estimate the amount of sales that would escape State sales or use taxation of the vendor as a result of jurisdictional limitations, if all States levied uniform sales and use taxes.[67] It grossly understates the proportion of such sales that do in fact escape taxation by particular sales- or use-tax States, for less than half of the States levy sales taxes, and even fewer levy use taxes. Furthermore, the laws of some States, by exempting sales "made in interstate commerce," may inhibit these States from collecting taxes on sales that are within their power to tax under United States Supreme Court interpretations. Finally, merchandise brought into, or shipped into, some rural States by local consumers is frequently quite an important percentage of total sales, especially if neighboring States contain large trading centers to which many residents of a taxing State go for merchandise. On this point it is impossible to generalize.

The competitive inequities resulting from the levy of nonuniform retail sales and use taxes by *all* States would, of course, be removed under a Federal retail sales tax. Furthermore, the present incentives to do a tax-free mail-order business from a central location, which induce some retailers to eliminate their local stores, would disappear under Federal retail sales taxation.

(*d*) *Other interstate problems.*

Congress has frequently been urged to allow the States to tax incoming goods. On principle, a case could be made for such action. It would involve no protective aspects if the nondiscriminatory character of the tax were insisted upon. If States are to attempt to tax the consumption that takes place within their borders, there appears to be excellent reason why they should do so in such manner as to tax all the consumption without discrimination. The weakness of the proposal lies in its means of enforcement. The American people would certainly be greatly and justifiably alarmed at the prospect of little custom houses at the intersection of all railroads and highways with State boundary lines. Such limited developments of this sort as have occurred (ports of entry) have already caused considerable alarm. The nuisance impediment to commerce, and the cost of compliance with even nondiscriminatory taxes on interstate commerce, would constitute a conclusive objection to any such solution of the problem. Certainly, taxes on interjurisdictional trade for units smaller than States would meet with prohibitive objection.

Another aspect of retail sales taxation that has coordination implications is the multiple taxation which arises when State A imposes a use tax with no credit for a sales tax which may have been levied by State B upon the same purchase. Of 17 States with use-tax statutes, 10 States provide a credit to avoid this type of discrimination. Although these credit provisions are desirable and should be encouraged, the problem of multiple taxation, in this instance, is not of very serious proportions.[68]

[67] In theory, taxes might be collected from consumers where vendors have not paid. In practice, this is feasible only to a limited extent.

[68] Maurice Criz, The Use Tax, Public Administration Service, Chicago, 1941, pp. 5-7, 46-47.

E. Stock-Transfer Taxes

A stock-transfer tax was employed by the Federal Government as an emergency measure before the First World War, when it became a permanent part of the Federal revenue system. The State of New York has taxed security transfers since 1905, shortly after the Federal emergency tax of the Spanish-American War period was abandoned. The latest figures show that the New York Stock Exchange accounts for 84.4 percent of the value of security sales on registered exchanges.[69] The New York tax was more severe than the Federal until 1941 and yielded more revenue. In 1942, five other States (Florida, Massachusetts, Pennsylvania, South Carolina, and Texas) were taxing security exchanges,[70] but outside of New York State the tax has been unimportant and apparently ineffective as to administration. Both the Federal Government and New York State increased their taxes during the depression, and the former raised its rates again in 1941.[71] The tax is relatively unimportant as a source of Federal revenue, but much more important as a source of State revenue in New York. Both the Federal and the New York taxes are based mainly on the number of shares transferred. This gives these taxes a somewhat freakish incidence. In addition, the double taxation of odd-lot transfers (those of small amounts of securities involving two transactions for each purchase) has been subject to very plausible criticism. As has usually been the case with overlapping taxes, specific provisions regarding exemptions, base of tax, and so forth, differ substantially in State and Federal laws.

A peculiarity of the stock-transfer-tax field is the degree to which it is concentrated in one State and the degree to which the incidence of the State tax falls on the nation outside the taxing jurisdiction. The best available information indicates that from 70 to 80 percent of the agency transactions on the New York Stock Exchange originate outside of New York; the agency traffic amounts to from 70 to 80 percent of the total. It is, therefore, safe to conclude that at least half of the business on the New York Stock Exchange originates outside New York State. The State law is so constituted that any transaction which touches the New York Stock Exchange in any one of the stages involved in security sales is taxable in New York. Undoubtedly the burden of this levy is widely diffused throughout the country.

Those interested in security trading have one main defense against excessive State taxation—the threat to migrate. In 1933 the Exchange, faced with increased State taxes, and threatened with a tax by New York City in addition, went so far as to rent quarters in Newark, N. J., and only abandoned this program after the original city tax proposals had been defeated.[72] A milder form of migration consists of a shift in business to the smaller exchanges in several other American cities. These other exchanges have been quick to press their advantage, but with no very conspicuous success. The general belief in the superiority of the trading facilities of the New York Exchange gives it some margin for taxation without too great a hazard of driving away the tax base.

[69] Seventh Annual Report of the Securities and Exchange Commission, fiscal year ended June 30, 1941, p. 288.
[70] Tax Systems, ninth edition, 1942, p. 224.
[71] Section 521 (a) (5), Revenue Act of 1941.
[72] New York Times, September 27, 1933.

The case for coordination of Federal and State taxation of stock transfers rests mainly upon the contention that the Federal and State taxes are levied without much regard for each other, and that the combination is excessive. It is further alleged that, as in most cases of overlapping taxation, the resulting costs of compliance and administration are unnecessarily high. As previously stated, New York City also has expressed an interest in taxing exchange transactions, and on principle, there would seem to be almost as rational a ground for a city as for a State tax. If this interest were translated into action, the problem of coordination would be aggravated.

The proposals for coordinating stock-transfer taxes have been confined largely to the idea of applying a credit for State taxes in the payment of the Federal tax on the order of the credit now applied in the case of death and pay-roll taxes. The credit in the stock-transfer-tax field is objectionable, however, because it would encourage State taxation of a source best suited to the Federal Government. While a Federal credit for State taxes would be principally beneficial to New York, it would probably stimulate other States to enact stock-transfer-tax laws. This would be bad not only because further exploitation of this field by the States should not be encouraged, but also because the possibilities of multiple taxation of stock transfers are very good. States domiciling any party to the exchange or the corporation whose stocks are involved, or States in which any facilitation of the transfer occurs, might assert a claim. Multiple taxation has not created much embarrassment in this field thus far, but it would be very unwise to stir up this hornets' nest of latent possibilities. Revenue sharing might be used as a coordination plan, but the formula of distribution, in the interest of equity, would probably follow the residence of buyers and sellers rather than the location of exchanges. The complications of distribution would be too great to be warranted for such a fiscally unimportant tax. The present arrangements are by no means intolerable. The stock-transfer tax is relatively simple to administer (by means of stamps) and double compliance and administration costs are not very serious. It may be doubted that the load of the two taxes is excessive, but if this is the case, the burden could be considerably eased by eliminating some of the crudities in the present stock-transfer-tax laws. Moreover, New York State, whose interest in a flourishing exchange is directly at stake, will probably reduce its rate of taxation if the combined burden can be demonstrated to be unduly repressive. The State is not so hard-pressed for revenue that it cannot find other sources.

Some concern may be felt lest a combination of Federal and State taxes trespass upon the national interest in liquidity, but this has not as yet been seriously contended. This interest has also to be remembered in considering income-tax provisions for capital gains and losses.

In conclusion, the stock-transfer tax, because of its incidence, is best suited for national exploitation, and on this ground separation of sources, with the tax to be levied by the Federal Government, might be recommended. But New York has a strong proprietary interest in the stock-transfer tax and is not likely to surrender it except under considerable pressure. The revenue from the tax is relatively much more important for New York State than for the Federal Government. Under the circumstances, the best recommendation appears to be that of forbearance, with most of the restraint to be exercised by New York State. Closer cooperation as to the details of legislation and administration, looking toward the development of greater uniformity is also recommended.

F. Pay-Roll Taxes [73]

1. UNIQUE FEATURES

By the fiscal year 1941 pay-roll-tax collections represented about 10.8 percent of total Federal and State tax collections and had become a more important revenue source than Federal and State individual income taxes.

The pay-roll-tax feature of our revenue system, and the problems of intergovernmental relations created by it, are quite unique in several respects. The tax is one case of a Federal levy imposed for a special purpose and explicitly earmarked for that purpose—Social Security. Integration with the public expenditure program is so close that taxes and benefits can hardly be considered separately. Overlapping taxation of pay rolls is involved only in the case of the excise on employers for unemployment compensation. This instance of overlapping is unique in that a coordination device was arranged as a part of the system at the time of its inauguration. It is unique, also, in that the crediting device, principal coordinating instrument, was employed successfully to induce States to enact pay-roll taxes and unemployment compensation systems. On the expenditure side of the problem, State administrative costs are borne through a grant by the Federal Government. The combination gives the Federal Government an unusually high degree of control over unemployment-compensation systems. The control, in practice, however, is far from complete, and diversities are considerable.

In general, the State taxes are designed to take full advantage of the Federal 2.7 percent offset.[74] But the States have tended to go beyond the Federal Act in covering firms of smaller size than eight employees. Seven of them now cover all employees of one or more.[75] Only 25 States still have the same provision as the Federal Government. Although there are numerous individual variations, the States have tended to follow the Federal example as to exempted employment,[76] and all but two (Idaho and Nevada) have followed the Federal Government in the $3,000 maximum-wage-coverage provision. The taxes are collected on a quarterly basis.

2. TAX COORDINATION PROBLEMS

Coordination problems as to overlapping pay-roll taxes center principally around efforts to reduce costs of administration and tax compliance. Such data as are available show a considerable range in State collection costs, owing probably to differences in density of population, degree of industrialization, and size of the State. For example, Utah and New York, both with efficient administration, show a range of from 1.57 percent for the former to 0.75 percent [77] for the

[73] Based mainly upon a monograph prepared for this study: William B. Gates, Jr., Problems of Intergovernmental Relations in the Social Security System.

[74] As will be explained later, this does not mean that the 2.7 percent State tax is being maintained.

[75] Arkansas, Delaware, Minnesota, Montana, Pennsylvania, Washington, and Wyoming.

[76] Bureau of Employment Security, Comparison of State Unemployment Laws as of December 31, 1941, Employment Security Memorandum No. 8, December 1941, p. 29.

[77] Collections from the records of the Social Security Board; other data from Time and Cost Distribution Survey for 32 Selected States, Bureau of Employment Security, March 10, 1942.

latter. Estimates of Federal costs place the figure at 0.68 percent.[78] As is the case with most other taxes, no adequate information concerning pay-roll-compliance costs is available. That these costs are quite high is agreed, the principal problem arising from the failure to integrate old-age-insurance pay-roll taxes with unemployment-compensation pay-roll taxes. Excessive reporting and other inconveniences result as much from the two Federal as from the overlap of Federal and State taxes. Very little can be done in the way of coordination until the Federal unemployment-compensation law is amended to cover employees of one or more, thus making the coverage similar to that under old-age and survivors insurance. Efforts to coordinate the two Federal taxes, and the coordination of State forms and procedures for unemployment compensation with Federal forms and practices for old-age and survivors insurance would be expedited. Twelve States had already taken this step on their own initiative by 1941. On the other hand, it is true that if the State tax were eliminated, the integration of the Federal taxes would be made easier and administration and compliance costs would be considerably reduced. This, however, would involve complete centralization of the unemployment compensation system and many implications broader than the issue relating to taxes.

It seems apparent that the major savings to be made in tax administration in the social security field are on the compliance side. An informed source at the Bureau of Internal Revenue estimates that a small firm employing from 500 to 1,000 workers would need an additional full-time person on its accounting staff to take care of social security compliance, and that this might involve an expense of from $1,200 to $1,500 per annum. It seems likely that this is a minimum amount.

The possibilities of high compliance costs are evident. An employer of eight or more must file an annual Federal unemployment-compensation tax return; he must file a quarterly State unemployment-compensation-tax return; he must file a quarterly old-age and survivors insurance return. He must keep wage records for all three taxes, and must deal with the Federal Government five times a year and with the State four times. It is not surprising that there should be complaints and that one State unemployment compensation administrator should say: "Has the possibility of handling all the collections for both unemployment compensation and old-age and survivors insurance through the Bureau of Internal Revenue been explored? The employers think that it has not." [79]

An amendment to the Federal Act in 1939 represents some progress toward general coordination of pay-roll taxes. The unemployment tax was made similar to the old-age and survivors insurance tax by redefining the taxable wage to include only the first $3,000 paid to an employee. The unemployment compensation tax base was modified to cover "wages paid" rather than "wages payable." All movement in the direction of identical procedures in the various pay-roll taxes (uniform coverage, for instance) tend to simplify the coordination problem.

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[78] See p. 307.

[79] Ernest Kelly, "Some Urgent Problems in Unemployment Compensation Administration," Social Security in the United States, 1941, American Association for Social Security, 1941, p. 53.

In the fiscal year 1940, returns were being made by 367,670 employers for unemployment compensation and 1,967,100 for old-age and survivors insurance.[80] The unemployment-compensation returns were on a yearly basis, while the old-age and survivors insurance were on a quarterly basis.[81]

A difficulty has arisen in the inability to decentralize the machinery of the unemployment compensation collection system. The Bureau of Internal Revenue has been able to decentralize most of the record keeping of the old-age and survivors insurance system to the 65 Federal collection districts. This has not proven feasible for the unemployment-compensation tax because of the State-credit system. Some firms handle the Federal return from their home office, while others work independently from each plant as they deal with the State systems. With the old-age system, reports on wage records are sent directly to the Social Security Board from the field offices.

A problem of coordination at the Federal level arises because of dual administration by the Bureau of Internal Revenue and the Social Security Board. Cases have arisen of differences in definition of "taxpayers" used by the Bureau and of "benefit receivers" as used by the Board.[82] The Bureau looks upon the social security taxes as similar to other taxes, to be sought vigorously if warranted by the cost of collection. On this rule of procedure, some taxpayers, notably small employers, are likely to escape rigorous enforcement.

There is a substantial case for the transfer of pay-roll tax administration from the Bureau of Internal Revenue to the Social Security Board. This coordination of benefit and tax-raising functions has already been adopted by the States and is the method used by practically all foreign countries. Issues of benefit rights and tax liability should be settled simultaneously by one agency, and social-security taxes cannot be thought of in quite the cost-as-against-returns sense, more appropriate to ordinary tax administration. Finally: "While the coordination needed in the administration of pay-roll taxes involves both Federal and State operations, it could be achieved more readily if all Federal aspects of the social-security program, including the payroll taxes, were administered by the Social Security Board." [83] This change is not now recommended because the inauguration of collection at the source may change the balance of advantages in favor of collection of income and pay-roll taxes by the same agency, as at present. The matter merits reconsideration later.

3. INTERSTATE COMPETITION AND THE UNDERMINING OF TAX STANDARDS

The crediting device was incorporated into the unemployment compensation system partly to counteract interstate competition. However, the threat of interstate competition has reappeared in the operation of merit-rating systems under which, in States that apply them, concerns with good employment records are granted a pay-roll tax

[80] U. S. Treasury Department, Annual Report of the Commissioner of Internal Revenue, fiscal year ended June 30, 1940, pp. 10-11.

[81] The reasons for this difference in time of payment are not altogether clear. It seems that the Internal Revenue Bureau justifies the quarterly return on the grounds that a large amount of money is involved which the Government does not want to leave in the hands of employers. An additional reason seems to be to assure collections from small, unstable employers.

[82] Mostly in the field of old-age and survivors insurance.

[83] Raymond C. Atkinson, Federal Role in the Unemployment Compensation Administration, Report for Committee on Social Security, Social Security Research Council, 1941, p. 23.

advantage. If all States adopted similar merit-rating schemes, this might be unobjectionable. Advantages would represent only the incentive which the merit-rating system is designed to supply. Where only part of the States adopt merit rating an element of unfair competition appears and if merit rating is used (as alleged) as a pretext for general undermining of tax standards, the competition begins to involve States as well as firms. Table 71 shows the prevailing rates in certain States.

TABLE 71.—*Estimated effect of experience rating on employer contribution rates and State unemployment tax revenues, 16 States, 1941*

State	Average contribution rate based upon 1940 pay-roll distribution	Loss in revenue	Percentage decrease in contributions under State standard rate
	Percent	*Thousands*	*Percent*
Total	2.1	$58,065	23
Alabama	2.0	2,632	26
California	2.4	7,530	11
Connecticut	2.2	4,415	19
Hawaii	1.4	1,365	48
Indiana	2.2	5,500	19
Kansas	2.0	1,491	26
Kentucky	2.6	355	4
Minnesota	2.1	3,072	22
Nebraska	1.3	1,834	52
New Hampshire	2.5	278	7
Oregon	2.6	326	4
South Dakota	1.6	457	41
Texas	1.5	11,088	44
Vermont	2.4	209	11
Virginia	1.6	5,709	41
West Virginia	2.4	1,443	11
Wisconsin	1.4	10,361	48

Source: Social Security Board, Social Security Bulletin, June 1942, p. 10.

In 1941, 34 States amended their benefit provisions, thereby effecting a total benefit increase of 20 percent for these States.[84] Ratios of reserves to highest yearly benefits show wide variations. The range in the ratio of reserves to highest yearly benefits is from 10.96 and 10.48 in the District of Columbia and New Jersey, respectively, to 1.15 and 1.38 in Nevada and Idaho, respectively.[85]

Imposition of Federal minimum standards as to tax rates, benefits, or reserves, preferably the latter, would mitigate this problem, but it would go far toward undermining State responsibility and independence. Pending a further opportunity for States to demonstrate their competence in the field of unemployment compensation, no change is recommended except that the Social Security Board assume an educational role, privately and publicly informing States when reserves or benefits are thought to be substandard.

4. PROPOSED CHANGES IN THE PAY-ROLL TAX CREDIT AND ADMINISTRATION GRANT

Many suggestions have been made for various changes in the present credit-grant combination which constitutes the coordination scheme of unemployment compensation. All these proposals have some ad-

[84] "Unemployment Compensation Legislation of 1941," Social Security Bulletin, 5:3, March 1942, p. 14.
[85] Social Security Board data.

vantages, but insufficient in most instances, it is believed, to warrant serious consideration. Increasing the Federal credit from 90 to 100 percent is a possible innovation that merits attention. This would go far toward the elimination of the Federal tax and the administrative and compliance costs which attend it. The change would, of course, involve some loss of revenue to the Federal Government.

The 100 percent grant for collection of State pay-roll taxes and the administration of State unemployment compensation systems is unique in the annals of American intergovernmental fiscal relations. It was designed as a means of securing very substantial Federal control, and as a method of assuring the availability of plenty of funds for the administration of a new and difficult function. It was thought that under a traditional matching arrangement the function might be starved in the poor States. The Board has felt free to exercise a wide degree of discretion in determining the allocation of funds to the States and has carried out a remarkably detailed job of supervision. Although this has involved friction, it has also meant insistence upon personnel standards, with salutary results not only in the welfare field but in State administration generally. The system has, however, sacrificed the safeguards against waste which attend State budgetary criticism and supervision. "One can literally count on the fingers of one hand the States in which the State budget officer actually reviews and revises the budgets of the employment security agency." [86] Some recasting of the program to give the States an equity in the administrative outlays, perhaps variable in degree, depending upon the financial ability of the States, would have much to recommend it.

5. OTHER COORDINATION PROBLEMS

In order to take care of the problem of a worker whose work for a single employer is performed in more than one State, all but 3 of the 51 jurisdictions have adopted a definition of "employment" which allocates a worker's entire pay roll to that State "in which he would most likely become unemployed and seek work." [87] Reciprocal arrangements have also been made by which out-of-State claims can be paid by the State in which the employee is residing. (By the end of 1939, all States were operating under this arrangement.)[88] This technique has worked remarkably well, but it does leave one problem unsolved. There is no provision allowing a worker to accumulate benefits on an interstate basis; it is possible that a worker will have his wage record split up in so many States, that he will have rights in none of them. However, the problem does not appear to be serious.[89]

Before the President's administrative reorganization in 1939 there was confusion at the Federal level on the expenditure control side of

[86] Raymond C. Atkinson, op. cit., p. 45. Variations in the costs of State administration of the entire unemployment compensation program are indeed startling. Only confidential figures are available but they are sufficient to establish that the cost is quite substantial in all States and that the range from the highest to the lowest is more than 4 to 1.

[87] "Interstate Industrial Migration as Reflected in Claims for Unemployment Compensation Filed in 1939," Social Security Bulletin 4:9, September 1941, pp. 20-27.

[88] Ibid., p. 2. The system works as follows: A worker must first exhaust whatever benefit rights he has acquired in his State of current residence before filing for claims in another State. His claim thereafter is determined by his order of employment in other States—the State of first employment being the one first liable.

[89] I. C. Merriam and E. T. Bliss, "Effect of Migration on Unemployment Benefit Rights," Social Security Bulletin 4:9, September 1941, pp. 3 ff.

the problem caused by split authority as to unemployment compensation (Social Security Board) and the Employment Service (Department of Labor). These two closely related functions are now combined at the Federal level in the Social Security Board. Since the Employment Service has been completely federalized during the war some confusion has arisen between State and Federal administration.

6. FEDERALIZATION OF THE UNEMPLOYMENT COMPENSATION SYSTEM

The case for complete nationalization of unemployment compensation is an attractive one. Beside the possibility of better coordination on the tax side, as previously mentioned, consideration must be given to the fact that unemployment is largely a national problem; that the Social Security program can be most effectively planned as a whole; and that the present State programs are quite limited both in scope and degree. On the other side there is the interest in experimentation with different techniques and concepts of unemployment compensation, and in the allowance for diversities, which may be desirable in a large country. A law suited for New York may be badly adapted to Nebraska. Were the program inaugurated now, it is probable that a national system would have the preponderance of advantages. Since the States have been granted the leading role in the system, they should be given time and Federal assistance to demonstrate whether they can handle it successfully. Constant threats to federalize the function will only interfere with cordial Federal-State relations.

It is unfortunate that the centralization issue has become mixed with that of merit rating. It is generally assumed that federalization would mean the end of merit rating. If this be true, it is the result of the attitudes of Federal and State administrators; there is no necessary conflict between nationalization and merit rating. (The feasibility and desirability of merit rating as an incentive to stabilization of employment and a means of distributing the cost of unemployment on cost-accounting principles is a many sided subject upon which competent opinion differs.[90] A discussion of this issue here would carry us too far afield.)

On January 19, 1942, the President sent a message to Congress requesting $300 million for extended unemployment compensation benefits as a means of meeting the problem of priority unemployment.[91] The proposal as brought before Congress [92] provided mainly for the recommended appropriation in order to augment all existing benefits by 20 percent; to extend to 26 weeks the duration of benefits; and to extend coverage, exclusively with Federal funds, down to employers of one person where such coverage was not already provided by State law.

The furor that followed the introduction of this proposal and its ultimate defeat in committee is probably the most significant development affecting the future of the unemployment-compensation system that has taken place in a number of years.

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[90] Cf. Charles A. Myers, "Employment Stabilization and the Wisconsin Act," American Economic Review, vol. 29, December 1939, pp. 708-723; Emerson P. Schmidt, "Incentive Taxation with Special Reference to Unemployment," Proceedings of the National Tax Association, 1941, pp. 464-477; Harry Weiss, "Unemployment Prevention Through Unemployment Compensation," Political Science Quarterly, vol. 53, March 1938, pp. 14-35.

[91] Communication from the President, January 19, 1942, House Document No. 589, 77th Cong., 2d session.

[92] H. R. 6559, 77th Cong., 2d sess.

Representatives of the States immediately took the stand that this was a veiled attempt at federalization and rallied their forces for an all-out fight. The Governors of Minnesota, Indiana, Massachusetts, Maryland, Alabama, North Carolina, and New Hampshire testified before the House Committee on Ways and Means against the bill. Twenty-two other Governors wired their opposition.[93] Much of this opposition sprang from a much-quoted line in the President's message including a remark that in his opinion the "best solution of the problem would be a uniform national system of unemployment insurance with adequate benefit provisions."[94] The attempt to block the bill was successful and constituted a definite victory for the States and an enhancement of their prestige.

G. Miscellaneous Overlapping Excises

The few miscellaneous overlapping excises can be covered quite briefly. Chief among them are the taxes on electrical energy, soft drinks, and amusements.

The Federal Government entered the field of electrical energy taxation in 1932 and has retained its program since. It confined its tax to sales for "domestic" and "commercial" (as distinguished from "industrial") purposes. In addition to property taxes imposed on the utility business, many States impose special franchise taxes on electric-energy producers, measured by gross receipts or kilowatt-hours. In 1941, there were 21 States applying such taxes. The base of the State taxes differs from and is broader than the Federal, the former including sales for industrial as well as other purposes. The States were first to exploit this field, but opposition to Federal "invasion" came mainly from public-utility companies without much support from the States. It was probably the expectation of the States that the Federal tax would be shifted to the consumer by means of rate increases and that State revenues would not be disturbed. Utilities have protested that excessive taxation has resulted from the overlapping,[95] a matter which in view of rate regulation, probably depends mainly on the elasticity of consumers' demand. Costs of compliance are probably considerable, but are mainly caused by Federal classification rather than overlapping. In a communication to Under Secretary of the Treasury John W. Hanes, the Commonwealth Edison Co. of New York described compliance difficulties for the Federal tax as follows:[96]

> * * * probably in excess of 100,000 accounts a month in each of sixty-odd months which have been audited to date are in dispute as to classification, and * * * the costs of ultimately proving by competent evidence the factual situation will be substantially in excess of the tax involved, regardless of whether this burden is imposed upon the Government or the taxpayer.

The Federal classification also causes administrative difficulties. Unnecessary compliance costs are also observed in the diverse State and Federal requirements as to reporting and payments. Attention might well be given to the aspects of the problem emphasized above but in

[93] House Committee on Ways and Means, Hearings on H. R. 6559, 77th Cong., 2d sess., February 11-17, 1942.
[94] H. Doc. No. 589.
[95] Senate Finance Committee, Hearings, Amendments to the Revenue Act of 1932, 73d Cong., 1st sess., 1932, pp. 5, 8.
[96] Letter from J. K. Polk to J. W. Hanes, May 23, 1939, Division of Tax Research files, Treasury Department.

general the evils in the present overlapping are probably minor in character.

In the taxation of soft drinks, the Federal Government was first in the field (1917), but its levies have been intermittent. There is no Federal taxation in this field at present although in 1941 and 1942 a tax was proposed by the Treasury. As of February 1942, 14 States applied taxes directly on nonalcoholic beverages or on commodities entering their manufacture. The number has doubled since 1932, and there has been some stiffening of rates. Administrative problems in the field are substantial even for the Federal Government, which probably has considerable advantage in applying the tax at the point of manufacture. State experience in the field is not very encouraging.[97] Revenue yields have been disappointing because of obstacles in administration and the maleffects of soft drink taxes on the tax base. The relatively stronger administrative position of the Federal Government in dealing with an industry in which the most taxable sector is concentrated in a few plants belonging to interstate companies, suggests the conclusion that the field of soft drink taxes is one in which the States might well forbear in favor of the Federal Government.

The Federal Government has taxed amusements uninterruptedly since the World War. State amusement taxation began in 1921 when Connecticut—

> * * * provided that 50 percent of the amount paid to the Federal Government by any person subject to the Federal statute should be prima facie the amount due to the State.[98]

That this particular kind of State supplement is impractical was demonstrated when, following increased Federal exemptions and decreased State revenues, Connecticut in 1929 substituted an independent tax. A total of 34 States tax amusements in one form or another and of these 23 levy a tax on all major athletic events; the Federal Government taxes admissions generally, of which theater admissions make up the greatest part. Very little discussion is available on Federal-State relations in amusement taxation to show in what manner and to what extent conflict occurs. In only three or four States is the amount of duplication significant. Proposed Federal taxation of pari-mutuel betting raises the question of whether the tax base would not be impaired by an additional levy, or interfere with the policing of legalized betting by the States. However, the Federal Government has thus far rejected this proposal. Amusement taxes seem to have been successfully applied at both levels, without conspicuous advantages for either, or major problems in the overlap.

Federal special excises overlap State retail sales taxes to some extent. Here the question arises of whether the two taxes shall apply to prices before or after tax. Usually the policy followed is the former; legislators are loath to impose "a tax upon a tax."

H. Taxes: Concluding Observation

Recent decisions of the Federal Governments of Canada and Australia to federalize a large part of State tax systems for the period of the war place proponents of our overlapping tax system on the defensive.

[97] See, for instance, "Luxury Taxes," Tax Policy, 4:4, February 1937, p. 5.
[98] Letter from the Deputy Commissioner of Taxation cited in R. B. Tower, Luxury Taxation and Its Place in a System of Revenues, p. 68.

Conditions in the two federal systems differ somewhat from our own. These countries have a highly developed tradition of allowances (fixed grants) from the central governments to the divisions. State tax rates, particularly in the income-tax field, were substantially higher at least for some of the foreign states than in our own. The tradition of state and local autonomy was probably less highly developed. Certain coordination devices, notably income-tax deductibility, were more highly developed in this country than in the British federations but others such as joint administration were much less developed. Of course, even if there were no differences in conditions, it could not be concluded from these examples that the States should be excluded, in effect, from important tax fields, even during the war emergency. Fiscal independence is a large sector of general independence and the latter a large part of local self-government; this in turn has important democratic values for which we are fighting. It has been suggested that another major war might put an end to federal systems, everywhere. Whether or not this be true, it appears that a large degree of State and local fiscal independence does carry values of a very high order, and that they should not be sacrificed until the necessity is clearly demonstrated. It is not believed that this is yet the case. That State rights should yield to military necessity is generally conceded. That the war effort would be served by federalization of State revenue systems is, however, very doubtful. The Federal Government has enough on its hands, for the present, without assuming the responsibility for State finances unless this course would yield very important advantages in ordering its own financial program. That there would be some advantages may be conceded, but these advantages (up to the present and in the near future) seem outweighed by the disadvantages.

Proponents of local fiscal independence might well heed the trend of the times, however. Progress in intergovernmental fiscal relations can be made without federalization and may be a means of avoiding the latter.

CHAPTER IX

SPECIFIC EXPENDITURES

A. Welfare Expenditures

1. INTRODUCTION

Although the first State old-age assistance law was passed in 1914 and the first aid to dependent children law in 1911, the welfare programs on which the social-security grants were superimposed in 1935 were extremely sparse and chaotic.

In 1934 old-age pensions of some sort were being paid in 27 States, but only 19 of these laws were mandatory on counties, and in only 13 States was part or all of the cost assumed by the State government.[1] All but 3 of the States had laws providing for aid to dependent children, but in 27 the legislation was merely permissive, and in the country as a whole less than half of the counties with legal authority to grant aid were providing it.[2] The situation was much the same in the field of aid to the blind; 27 States had laws on their statute books, but only 19 of those laws were mandatory on localities.

By December 1941, a revolution had been wrought in these special-category fields. Although payments were still very low and great variations remained as between States, a solid foundation had been laid for a comprehensive system of social security. Over 2.2 million persons were receiving aid under State old-age assistance laws, in contrast with the 1935 total of 400,000. All States had been operating under laws acceptable to the Social Security Board since September 1938, and average payments to recipients had risen from the 1935 figure of around \$10 to over \$21.[3] State aid to dependent children programs was helping to meet the needs of over 944,000 children, in contrast to the 1935 total of from 270,000 to 280,000, while even in well-to-do States per capita expenditures for the function had tripled and quadrupled. Similar progress had been made in aiding the blind, and by December 1941, the number of recipients stood at 77,400, and average monthly payments per recipient had reached \$25.80.[4]

During the fiscal year ending June 30, 1941, the Federal Government expended over \$424 millions on social-security grants. Old-age assistance received 61 percent of the granted funds; unemployment compensation administration, 14.8 percent; aid to dependent children, 14.7 percent; and the remaining eight categories, a total of under 10 percent.[5]

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[1] Supplement to the Report to the President of the Committee on Economic Security, 1935, tables 14 and 15.

[2] Jane M. Hoey, "Aid to Families with Dependent Children," Annals of the American Academy of Political and Social Science, March 1939, p. 74.

[3] Alvin Roseman, "Old Age Assistance," Annals of the American Academy of Political and Social Science, March 1939, p. 54.

[4] Social Security Bulletin, 5:2, February 1942, p. 32.

[5] Computed from Receipts, Expenditures and Balances of the United States, for the fiscal year ending June 30, 1941; Treasury Department, pp. 716–717.

The Federal Government has a very substantial stake in the categorical aids. It provides 49.7, 40.6, and 47.3 percent of the funds spent for old-age assistance, aids to dependent children, and aids to the blind, respectively.[6]

There are a number of States in which the local share of assistance costs is equal to, or greater than, the State share. Such is the case in 3 States for old-age assistance; 10 States for blind assistance; and 16 States for dependent-children assistance. Localities are generally required to provide a heavier share of the administrative, than of the assistance, costs. In 11 of the old-age-assistance programs they put up more of the administrative costs than the States; the same situation holds for 11 of the aid-to-dependent-children programs, and 11 of the aid-to-the-blind programs.[7] The States requiring local sharing have done surprisingly little with equalization schemes. A half dozen at most have experimented with real equalization, while a number of others have made some attempt at aiding extremely poor counties.[8] Very little is known about the operation of these schemes, except that they have been neither far-reaching nor particularly effective.

2. PROBLEM OF A FOURTH CATEGORY

Since the passage of the Social Security Act with its grant provisions for the three special categories, there has developed a strong movement for the addition of a fourth category—general relief to aid the States in meeting a substantial residual welfare problem.

The movement for such an addition to the welfare grant system draws its major support from the conditions to be found among the general relief groups of the nation. The variation as among States in average payments per recipient is much greater in the relief than in the special category fields, and the whole range is at a much lower level of standards. In the fiscal year 1941 the average payment per case for the nation as a whole stood at about $24.41, which amounts to about $8 per person per month.[9]

During the fiscal year 1940–41 a little under $337 millions was spent by the States and localities for general relief payments. The over-all cost division for this expenditure was 56.3 percent State and 43.7 percent local. Thus localities play a much more substantial role in the general relief than in the special category fields. In only 4 States was no cost sharing required, while in 11 the entire cost was met by localities, and in 14 more, over a 50-percent local share was required.[10] Many of the States have earmarked special tax revenues to meet this expenditure.

Incomplete data indicate that the local share of administrative costs is even more substantial than that for assistance payments. In the 37 States for which there are data, 55.5 percent of costs is required from localities for administration, while 40 percent is required for assistance payments.[11]

[6] Social Security Bulletin, 4:11, November 1941, p. 30.
[7] Social Security Board, Bureau of Public Assistance, Division of Operating Statistics and Analysis, May 6, 1942.
[8] J. Gordon and O. Israeli, "Distribution of Public Assistance Funds Within States," Social Security Bulletin, 2:12, December 1939, pp. 23 ff.
[9] Social Security Bulletin, 4:2, February 1942, p. 31.
[10] Social Security Bulletin, 3:11, November 1941, p. 33.
[11] Social Security Board, Bureau of Public Assistance, Division of Operating Statistics and Analysis, May 6, 1942.

A major argument for the fourth category springs from the contention that Federal grants for the special categories have distorted State budgets, especially in the poorer States, and have reacted with particular force against State expenditures for general relief. There is a good deal of evidence supporting such a contention. In contrast with the majority of high per capita income States, the great majority of low per capita income States show extremely low figures for State and local expenditures for relief as a percentage of total State and local money provided for the welfare field. (The three special categories plus general relief.) For example, Mississippi, Tennessee, and Oklahoma show 3.68 percent, 6.78 percent, and 8.06 percent, respectively, as compared with New York, 77.09 percent, Rhode Island, 74.42 percent, and Pennsylvania, 68.86 percent.[12]

In spite of the fact that these figures are partially explainable in terms of less need for general relief in agricultural sections, the strong old-age-pension movement, and perhaps some shifting of general relief cases to the special categories, the evidence supporting the distorted budget idea seems very strong.

Although general relief should perhaps remain a predominantly State and local function, the Federal interest in the category is believed to be strong enough to justify a grant program; this interest is probably as strong, if not stronger, than that in old-age assistance.

The possibility is recognized that budget distortion may involve other fields of State and local activity, but it is felt that, until such a situation becomes clearly evident, the best policy would be an attempt to avoid such eventualities by going slow on a fourth category provision, rather than by refusing to experiment with such a scheme.

3. DIFFERENTIAL GRANTS

There is very mixed evidence of the correctness of the assertion that "the wealthy States receive a disproportionately large share of the welfare grants." There seems to be very little tendency for States with very high per capita income to have very high per capita grants. On the other hand, it is true that States with very low per capita income also have very low per capita grants.

The relation of State social security matching expenditures to per capita income is apparent in chart 13.

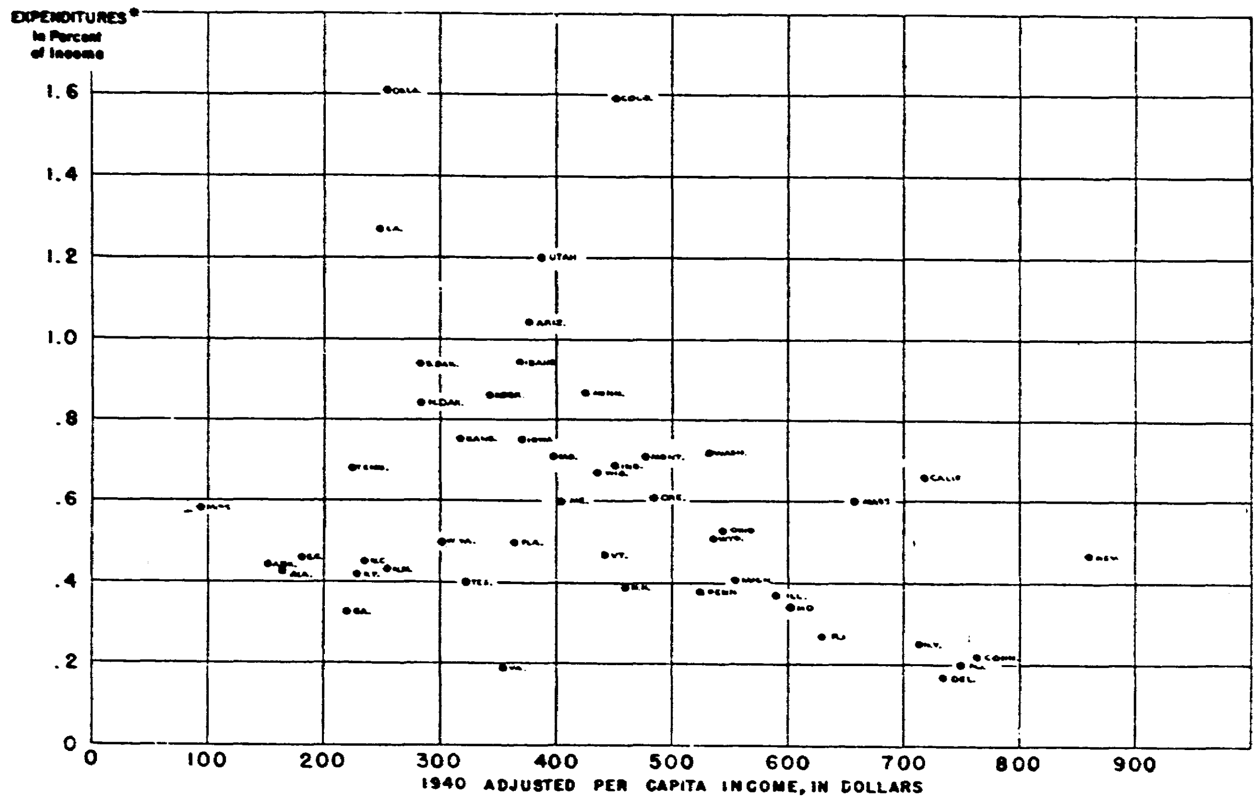
Statements to the effect that "poor States are unable to provide anything like reasonable levels of service without straining themselves financially" are in general valid, but there is some evidence that most of the very poor States are not making as great an effort to meet welfare needs as education needs. They allocate a very small part of total taxes to welfare purposes.

It is certainly true that if States provide approximately equal average benefits, the level of per capita income will be an important factor in determining the degree of burden, but it cannot be said with any great assurance that the present grant system puts a much greater burden on very poor than on very wealthy States.

The role of low per capita income in blocking further progress toward increasing average payments, under the present matching system, seems to be more indirect than direct. The difficulty is not

[12] A. Gall, Research and Statistics Division, Social Security Board.

PER CAPITA EXPENDITURES BY STATES ON SOCIAL SECURITY GRANTS AS COMPARED WITH ADJUSTED PER CAPITA INCOME



1940-41 Expenditures for matching Social Security grants as a percentage of adjusted per capita income in 1940

CHART 13.

so much that low per capita income States have already attained very high burden levels for the welfare functions, but rather that they are unwilling to increase the proportion of total taxes going to welfare, as against other governmental functions.

There is substantial evidence to support the contention that an absolute prerequisite for any liberalization of the welfare matching formula would be measures designed to assure internal State equalization.

In the first place, there is likely to be just as much or even more variation in per capita income and need within States as among them, thus placing the burden of determining the ultimate effects of the Federal grants on intrastate cost-sharing and grant allocation techniques. At the present time localities seem to play a substantial role in the determination of eligibility and benefit standards, and, where cost-sharing exists, it is quite possible that a variable grant would increase intrastate inequalities, by allowing wealthy counties to take advantage of a matching ratio that gives equal weight to rich and poor counties.

The few equalization attempts made by the States seem highly unsatisfactory.

The fundamentals of the variable-grant technique are easily outlined. The matching proportions are set up on the basis of some measure of fiscal capacity, varying in inverse ratio to this measure. Whatever formula is chosen, the method is designed to approach an ultimate of providing equal levels of service, at an equal burden as among States. The formula chosen, however, is a judgment question similar to that of choosing the rate of progression in an income-tax schedule.

A new technique was suggested by the Connally amendment, introduced as S. 3030 on January 4, 1940. The matching idea incorporated in this amendment forms the basis of the proposal recommended for adoption by this report.

The technique would be set up somewhat as follows: For the old-age program the Federal Government would match on a 66⅔ percent basis up to the first $15 per month of aid given eligible recipients; 50 percent from $15 to $25; and 33⅓ percent from $25 to $40. A similar graduated bracket system would be applied to the other three welfare categories. The system has a number of advantages.

A strong Federal interest in bare minimum standards can be given strong implementation by high matching proportions, and those matching proportions can be reduced in accordance with the rate at which the Federal interest is believed to decline.

It may confidently be expected that State money will be matched at a higher over-all proportion in the poor than in the wealthy States, thus providing substantial equalization without encouraging "disproportionate" spending for welfare functions by poor States.

A premium will be placed on intrastate equalization, since the maximum of Federal aid, in proportion to State expenditures, can be obtained by paying equal assistance grants to all recipients, within each category. This avoids the necessity of forcing States to adopt standardized equalization procedures. The graduated-bracket grant also avoids the difficulties of obtaining precise measures of fiscal capacity.

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4. PLACE OF WELFARE EXPENDITURES

Some question persists as to the emphasis which should be given to welfare and social security in the future. That the place must be considerable no one can deny. That substantial relief problems are inevitable, no one can deny. Even in relatively prosperous periods there is always need for assistance to a large number of people suffering from technological unemployment, personal deficiencies, and other maladjustments. Insurance against the contingencies of life in our modern risk-ridden era is highly appropriate. But the hope can still be entertained that major reliance for the future will be placed in public-investment programs which will insure abundance of opportunity.

B. Education Expenditures[13]

1. INTRODUCTION

Out of the very large field of expenditures for education, only a few high points, especially applicable to intergovernmental relations, can be considered here.

In the United States, the tradition of local autonomy in educational matters is very strong. It is hardly less so than in Canada, where the Constitution expressly states that the Provinces shall have exclusive power over education (art. 93). Education in the United States is probably the most decentralized major public function and central control is stoutly resisted. Local expenditures for education accounted for 88 percent of all education expenditures in 1941 as compared with 77 percent as the local share for police and other protection, 49 percent for highways and streets, and 20 percent for welfare. (See table 41, p. 358.) These percentages include local expenditures from State grants for these purposes. This explains why, in contrast to other Federal-aid proposals, most plans for grants for general education have carefully avoided any taint of Federal regulation beyond that of accounting for funds.

Although the Federal Government has had a finger in the educational situation for a long time, its present financial contributions run to only 2 percent of the total. A movement for more general and generous Federal aid, as described below, is not of recent origin, but it is becoming more and more insistent. The movement has been restrained thus far by fear of Federal control, sectional disputes over the equalization principle, opposition of religious groups, and the strained condition of national finances.

2. CONSIDERATIONS BEARING ON THE ADVISABILITY OF EXTENDING FEDERAL AID FOR EDUCATION

(a) Variations in effort and ability to support education.

That effort and fiscal capacity to support education differ strikingly, both as among States and among districts within States, has long been recognized.

The range of average school terms for different States is from 9½ to 6½ months, and in individual districts terms of 6 months or less are reported.[14]

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[13] Based mainly on a monograph prepared for this study: Russell J. Hinckley, Federal Grants-in-Aid for Education.

[14] The Advisory Committee on Education, Report of the Committee, February 1938, U. S. Government Printing Office, Washington, D. C., 1938. p. 21.

High school enrollment as a percentage of total enrollment ranges from 11 to 31 percent among States.[15] Percentages of illiteracy are being reduced, but a significant variation among States is noted.[16] Great disparity is revealed in availability of schools and libraries, in salaries paid, and in quality of buildings and facilities. School property in the highest ranking State has a value of $445 per pupil,[17] while in the lowest ranking State the value per pupil is as small as $75. In one group of States as many as 65 percent of the school buildings are of the one-room variety, while others have as few as 15 percent in this category. Ninety percent of all school buildings are in rural areas and two-thirds of these are one-room schools. The number of children housed in overcrowded and unsafe buildings, or who have no school facilities available within reasonable distance, is estimated to be nearly 5 million.

For the school year 1935–36, current expenditure per pupil in average daily attendance in rural areas averaged $67 as compared to $108 in urban areas. Current expenditure per pupil in average daily attendance ranged from $134 in New York to $25 in Arkansas. The United States average was $74, but three States were expending more than $115 and three, less than $30.[18] Average teachers' salaries (elementary and secondary), a major factor in expenditure disparities, were below $600 in three States and over $1,800 in three others. Current expenditure (excluding interest) per *weighted* census unit [19] averaged $40 for the United States in 1935. The range was from $85 in the District of Columbia and $74 in New York to $12 in Arkansas.[20] Twelve States spent less than $25 per weighted census unit; and all these were located in the Southeast and Southwest.

The markedly limited educational opportunity in the Southern States, compared with Northeastern and Pacific States, has been one of the strongest arguments for equalization aid. In the 14 Southern States, 1937–38 current expenditure per pupil in average daily attendance ranged from $28 in Mississippi to $65 in Texas. The high Texas figure was only 78 percent of the national average. The Southern States ranked below all other States but Maine in current expenditure per pupil. 1937–38 teachers' salaries in the 14 States ranged from $479 annually in Mississippi to $1,096 in West Virginia, as compared with the national average of $1,374.[21]

Not all the differences in extent and quality of school programs can be revealed statistically. It must be recognized that expenditures per pupil do not reflect quality or content of the educational program precisely, in view of such factors as differences in cost of living, size of district, size of school, density of settlement, relative proportion of high-school enrollment, type of building required by climate and location, policy as to provision of materials and textbooks, and weight given to vocational and other training requiring costly equipment. A

[15] "Federal Support for Education," Research Bulletin of the National Education Association, 15:4, September 1937, p. 161.

[16] U. S. Congress, Senate Committee on Education and Labor, "Federal Assistance to the States for the Support of Public Education," Report on S. 1305, 76th Cong., 1st sess., April 4, 1939, p. 4

[17] Ibid.

[18] Advisory Committee on Education, Report of the Committee, pp. 20, 224.

[19] The weighted census unit uses the number of children of school age as the base, and weights this figure to allow for (*a*) higher cost of small classes or (*b*) transportation, in rural areas and higher cost of living and higher teachers' salaries in urban areas.

[20] Advisory Committee on Education, Staff Study No. 5, Principles and Methods of Distributing Federal Aid to Education, U. S. Government Printing Office, Washington, D. C., 1939, p. 12.

[21] Southern States Work-Conference on School Administrative Problems, 'State and Local Financing of Schools," Improving Education in the Southern States, Bulletin No. 1, 1941, Tallahassee, 1941, pp. 73-74.

large number of one-teacher schools with small enrollments in the Plains States, may result in relatively high per pupil expenditures, yet the offerings are not comparable with those in more densely settled States spending the same average amount per pupil. All these factors combined do not account for the generally lower level of expenditures in the Southern States. The variations in expenditure are more closely related to the variations in per capita income than to population density, size of district, and similar factors. And the relative proportion of high-school enrollment is in itself partly a reflection of relative per capita incomes. The low average expenditure per pupil in the Southern States reflects, in part, a policy of maintaining a low level of expenditure for large numbers of Negro children.[22] This practice sometimes extends to failure of the local district to distribute to Negro schools the full per capita apportionment, or other State aids, to which they are nominally entitled by virtue of school population or enrollment. White-school expenditures alone are not as far below the average of other States.

Income per capita, income per child of school age, wealth per child, potential yields of a uniform tax system per child, and other indexes of economic and fiscal capacity are most significant in explaining differences in financial capacity. Among all States, wealth per child enrolled ranges from over $21,000 to less than $3,000.[23] Thirty percent of the children aged 5 to 13 are located in the Northeastern States with 43 percent of national income, and 24 percent of the children are located in the Southeastern States with 10 percent of the national income. Per capita income payments in 1940 averaged $573 for the nation. The range was from $195 in Mississippi and $253 in Arkansas to $1,022 in the District of Columbia, $960 in Nevada, and $864 in Connecticut. All 14 Southern States were more than $100 below the national average per capita income.[24]

The States of lowest per capita wealth, income, and taxpaying ability tend to have the largest numbers of children relative to adult population. The 14 Southern States, for example, with low per capita income, have 34.5 percent of the children enrolled in public schools, and collect only 17.4 percent of total revenue available for public schools in the nation.[25] The relatively low revenues are partly due to low wealth and income.

Differences in fertility rates in the different States and regions result in an uneven distribution of the educational burden to be carried by the adult population. The productive population of the Southeast must carry a burden of child support and education at elementary levels that is 80 percent greater than that of the Far West, and 44 percent greater than that of the Northeastern and Middle States.

[22] Although the practice of differential treatment is not to be condoned, total expenditure might not be materially larger, in view of fiscal ability, if such a policy were not followed.

[23] Senate Committee on Education and Labor, Report on S. 1305, p. 5.

[24] Federal Security Agency, Social Security Board, Fiscal Capacity of the States: A Source Book, Bureau Memorandum No. 43, supplement, January 1942.

An index of financial ability based on the estimated yield of six taxes (personal income, business income, real estate, stock transfer, severance, and corporation organization) reveals that in 1935 New York State had 21.4 percent of all financial ability and 8.7 percent of educational need, while Mississippi had 0.5 percent of financial ability and 1.94 percent of education need. Principles and Methods of Distributing Federal Aid for Education, p. 87. The 14 Southern States combined had only 15.7 percent of taxpaying ability, yet had 33.8 percent of all educational need.

[25] Southern States Work-Conference on School Administrative Problems, op. cit., p. 75.

TABLE 72.—*Number of children of school age relative to number of adults, 1930*

Region	Number of children per 1,000 adults aged 20-64		
	Ages 5-13	Ages 14-17	Total 5-17
1. Southeast	426	177	603
2. Southwest	380	157	537
3. Northwest	350	146	496
4. Middle States	297	126	423
5. Northeast	295	125	420
6. Far West	236	100	336

Source: Newton Edwards, Equal Educational Opportunity for Youth, American Youth Commission, Washington, 1939, p. 40.

Much wider variations prevail among the States. South Carolina had 739 children aged 5 to 17 per 1,000 adults, while New York had but 363 and California but 319. Of 126 counties in which the number of children aged 7 to 13 per 1,000 adults aged 20 to 64 was 200 or less in 1930, only 12 were in the Southeast. Of 365 counties with ratios of 400 or more, 298 were in the Southeast.[26]

The Advisory Committee on Education pointed out that over 60 percent of the children of school age lived in States which could not raise $50 per child for public schools without more than average effort. States of more than average financial ability were making less than average effort, and States of less than average ability with few exceptions were making more than average effort.[27]

The 14 Southern States previously described as having 34.5 percent of total public-school enrollment and 15.7 percent of taxpaying ability (estimated yield of 6 taxes) were collecting 17.4 percent of the total revenue available for public schools in the nation in 1937-38. All 14 States ranked below the national average in tax resources per child, yet 13 exceeded the average national effort [28] to support public schools. The percentage of 1-room schools in these States was below the national average and 56 percent of all consolidated schools were located in the South. The size of administrative districts in these areas was considered, with few exceptions, to be in advance of most other areas in view of wide use of the county unit. In spite of low salaries, white teachers in the South compared favorably in qualification with teachers of other areas. Six of the States ranked above the national average in percentage of teachers with 2 or more years of college training. Six others ranked above one-fourth of all States. Only two fell in the lowest quartile. The Southern States led the nation in the percentage of public-school revenue derived from State sources and have developed relatively advanced distributive systems. Most of the States have diversified tax systems, although consumption taxes are relied upon heavily. The Southern States surpass most other States in percentage of tax revenue derived from nonproperty tax sources.[29]

[26] Edwards, Equal Opportunity for Youth, p. 46-47.
[27] Advisory Committee on Education, Report of Committee, p. 29.
[28] Calculated as the ratio of amount spent for education to estimated financial resources, the latter determined by estimating the yield of a uniform system of selected taxes.
[29] Southern States Work-Conference on School Administrative Problems, op. cit., pp. 74-75.

Using an index of financial ability based on the estimated yield of a uniform system of selected taxes, Mississippi would have had to exert 55 times as much effort as Delaware to provide a minimum program of $60 per unit of need in 1930, devoting 181.8 percent of tax resources to education as against 3.3 percent in Delaware. Nevada would have had to put forth less than one-fifteenth as much effort as Mississippi, using but 12.2 percent of tax resources.

(*b*) *Dispersion of the results of education.*

The migrations of population are stressed as one of the more significant evidences of a national interest in educational opportunity, and of the interest of the wealthier industrial States, which will derive many future workers and citizens from poorer areas.

Data on migration are available in considerable volume, including the recent compilations of the Tolan committee. Population shifts of the war period offer striking evidence of potential mobility.

Perhaps the most impressive single reflection of interstate mobility is the fact that in every census since 1850, more than 20 percent of the persons born in the United States resided at the time of the census in States other than those in which they were born.[30] In 1930, for example, 23.5 percent of the persons born in the United States were living outside of the State of their birth. California was the only State which had not lost at least 15 percent of its native-born population to other States. Fifteen States had given up to others over one-third of their native-born whites.[31] In the twenties, the 10 States of the Southeast, for example, lost 1.7 million persons to regions presenting "greater opportunity." The evidence could be multiplied to demonstrate significant gains and losses by individual States through migration. In addition, there have been extensive farm-to-city and city-to-farm flows of population, some of which are interstate in character.

From 1920 to 1930, 60 percent of the net farm-to-city migration, or 3,437,000 people, came from the Southeastern and Southwestern regions. One-third of the migrants from southern farms were Negroes; the migrants also included a large proportion in the younger age groups.[32]

(*c*) *Fiscal considerations.*

A further factor urged to support Federal aid is the fiscal one. Some proponents of Federal aid start with the argument that Federal taxation is superior to State and local taxation from the point of view of fiscal adequacy, administrative efficiency, equity, and economic effects. Federal aid is held desirable as a tax reform to relieve the overloaded State and local tax system.[33]

(*d*) *Other considerations supporting Federal aid.*

Other economic arguments offered in support of Federal aid emphasize the importance of public education in raising the level of consumption and production in subaverage areas. Also stressed are the possible effects of more adequate education in reducing future outlays

[30] "The Efforts of the States to Support Education," Research Bulletin of the National Education Association, vol. 14, Washington, 1936, p. 152.
[31] Edwards, op. cit., p. 124.
[32] "Federal Support for Education," Research Bulletin of National Education Association, p. 169.
[33] Clarence Heer, Federal Aid and the Tax Problem, Advisory Committee on Education, Staff Study No. 4, 1939.

for relief, health, welfare, and rehabilitation. Citizenship interests in minimum standards for education are obvious.

(*e*) *Arguments against Federal aid.*

In opposition to further Federal support for education is the strong fear that the control of this field will pass out of local hands, and the considerable disagreement as to how Federal aid should be distributed and as to the conditions that should be included in the plan of distribution. In addition, the Federal Government itself has had no idle surplus funds available for aid purposes in recent years. Exception is also taken to the view that the so-called ability taxes can carry indefinitely expanded loads of direct Federal expenditure, as well as constantly increasing grants for various State-local functions promoted by pressure groups. Concern is also expressed as to the propriety of carrying the support of such primary functions as education on a sustained deficit-financing basis, including their incorporation in post-war public works spending programs. The general objection to aids—that they make for extravagance—is also urged.

(*f*) *Conclusion.*

Undoubtedly there are very large numbers of persons in the United States who believe that State and Federal participation lead mainly to extravagance and regimentation, and that education should remain a local function of government. Against this position stand the growing interdependence of the national economy, the migration of large numbers of citizens, the inequality in load, effort, and ability, and the strategic position of elementary education, at least, in the objectives of democracy. The decision is not one that can be drawn in terms of a quantitative balance, and it is one upon which reasonable men may differ. To the authors of this report it appears that the balance supports an affirmative judgment.[34]

3. HISTORY OF FEDERAL AID FOR EDUCATION

Federal aid commenced as early as the Ordinance of 1785, when the rectangular survey of the public lands was ordered, and regulations for disposal of lands in the western territory provided for reserving section 16 in each congressional township for the maintenance of public schools. Massachusetts and Connecticut had also granted land for public schools, although at the time the Constitution was inaugurated education was not generally regarded as a public function outside of New England. In 1800, only 7 of 16 States mentioned education in their constitutions as a public function. The Federal grants of land were continued and expanded by Congress when Ohio entered the Union in 1803, and upon the entrance of other States in later years. No controls or specific educational conditions were attached to these grants. Over 250 million acres of public lands were ultimately granted to the States for various purposes; nearly half of this went to educational purposes. The record of waste and mismanagement is

[34] Federal aid to education was introduced early in the history of the Swiss and Argentine Federations, and both have continued it. Brazil introduced educational aid in 1918. It is also found in Mexico. The Union of South Africa's main grant to the Provinces is primarily for this purpose, and the entire Union subsidy is distributed in proportion to school children and teachers, although the money is not earmarked for this purpose. Canada, like the United States, has provided Federal grants only for special types of education, and in small amounts; and Australia and Germany have left education to State and local support.

well known, although some permanent State school funds created out of early money and land grants survive.[35]

The proceedings of the Constitutional Convention reveal that Madison and others understood the general-welfare clause as including public education, and that Monroe, Hamilton, and Jefferson grouped education, public works, and Federal aid under the same clause.[36] Some intent was evident to include responsibility for education in the enumeration of Federal powers. The lack of express authorization of Federal support for education in the Constitution has not been held to evidence a lack of national interest in the problem, nor a lack of congressional authority to provide financial assistance.

In 1862 the first Morrill Act provided for endowment of agricultural and mechanical colleges through grants of land, land scrip, and sale of lands. This set the pattern of aid to stimulate selected activities. The only elements of control were the limitation of use of the grants to the specific technical-school purpose and the requirement of military instruction.

In 1887, specific grants of money from sale of public lands were extended to agricultural experiment stations. In 1890, the second Morrill Act further endowed the agricultural and mechanical colleges by cash grants. More specific controls were written into the law by providing that no race discrimination be practiced in the use of funds, and by authorizing withholding of grants for cause.

A number of extensions of these laws and increases in distributions have been made down through the Bankhead-Jones Act of 1935.[37] The provisions are not sufficiently important, from the monetary standpoint, to warrant detailed description.

In 1914, annual money grants were made for agricultural and home economics extension work, and further increases were accorded in the Capper-Ketcham Act of 1928 and the Bankhead-Jones Act of 1935. The Smith-Hughes Act of 1917 offered aid to vocational education, and applied for the first time to education the matching provisions initiated in the Weeks Forest Aid Act of 1911.

This set a pattern for subsequent development of the plan of matching grants, and Federal supervision and inspection of State-administered operations. Aid was extended to secondary schools for vocational agriculture, home economics, and industrial trades. Discretionary power was vested in a Federal board, although the powers were explicit in the law, permitting the board to determine the extent to which the States met the objectives and standards set.

The pattern of matching grants which has since developed has been widely attacked as ignoring differences in financial ability and as distorting educational programs by attracting funds to the aided activity. Lodging of full discretionary power with Federal agencies is also believed, by some educational groups, to permit dangerous latitude for Federal control.

The vocational-education-aid funds have been considerably expanded in amount, and extended to the teaching of the distributive trades as well, by the George-Dean Act of 1936 and other legislation.[38]

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35 The distributions included gifts of saline and swamp lands, proceeds of sale of public lands, surplus Federal revenues, special land gifts for internal improvements, and increased land grants upon admission to the Union.

36 Washington and several other Presidents advocated Federal aid to higher education and recommended establishment of a national university.

37 7 U. S. C. 301–308, 321–343g, 341–348, 361, 386, 386a, 427, 427g; 64 Stat. 562.

38 20 U. S. C. 11–30; 20 U. S. C. 15i–15p, 64 Stat. 563.

Federal aids for vocational rehabilitation have also been supplied since 1920.[39]

Prior to the depression most of the Federal aid to selected services was distributed on a population basis without reference to relative needs, and was conditioned upon the matching of Federal funds and Federal approval of activities. Considerable Federal emergency assistance to education was developed during the depression, although some was not directly in aid of local units. The Federal Emergency Relief Administration program, 1933–35, assisted in keeping schools open by giving aid to needy teachers in rural areas, and in cities under 5,000 population, which had exhausted their own resources. Federal Emergency Relief Administration and Work Projects Administration programs were developed for nursery-school, adult, and vocational education, and the Civilian Conservation Corps and National Youth Administration programs included student aid and other educational activities. School construction and repair was promoted by Federal Emergency Relief Administration, Civil Works Administration, and Work Projects Administration programs, and the Public Works Administration loans and grants, and Reconstruction Finance Corporation loans. The defense period has seen a considerable expansion of vocational rehabilitation and vocational training programs financed with Federal funds. In addition to these activities, there are a number of limited or incidental distributions of Federal funds for education, including tuition payments for nontaxable Indians attending public schools, and the sharing of revenues from the national forests and other public lands with States for the benefit of roads and schools.

All Federal aid to States for education in 1939 was only $49.5 millions. In 1941, the total was $88 millions, owing principally to expansion of grants for defense training.[40] However, grants to the States for peacetime educational purposes provide, as previously stated, only about 2 percent of public school revenues.[41]

Proposals for Federal aid for general education were quite numerous during the later years of the nineteenth and early years of the twentieth century. During the 1920's a considerable movement for a Federal Department of Education with a cabinet secretary developed. The proposal included an appropriation for general aid. Programs for special or general aid gained momentum during the 'thirties when the local financial resources to support education shrank impressively.

The joint committee of the National Education Association and Department of Superintendence held a national conference on the financing of education in 1933, and suggested that extensive Federal support was now required as a national policy in view of modern developments in interdependence. Federal aid was held essential to enable all States to support a substantial foundation program of education of all children.[42]

In 1933 a Federal Advisory Committee on the Emergency in Education was formed by the Commissioner of Education. The conference of representatives of national organizations recommended a $400 million program of emergency aid to elementary and secondary schools, and aid to college students. The depression program was believed

[39] 29 U. S. C. 31–45b.

[40] Federal and State Aid: 1941; Bureau of Census, State and Local Government, Special Study No. 19, April 1942, p. 15.

[41] In 1937–38 Federal funds provided 1.2 percent of all public school revenue receipts. U. S. Office of Education, Public School Revenue Receipts by Sources, 1927–28 and 1937–38, January 1941.

[42] Paul R. Mort and Walter C. Reusser, Public School Finance, McGraw-Hill, N. Y., 1941, p. 474.

necessary to relieve the general property tax, to keep schools open, assist in refinancing school loans, promote school rehousing, and to initiate a system of general grants on the basis of ability. The $400 million program was designed chiefly as emergency aid, but it was supported also as a step toward a permanent program.[43]

In 1935 and 1936, considerable study and discussion was given the Federal-aid question by the National Education Association, associations of school boards and teachers, parent-teacher associations, and similar groups. The depression and resulting curtailment of school revenues and expenditures had raised some question as to the desirability of leaving the entire burden of financing upon State and local units. A number of studies of State fiscal ability to support education were made by Norton, Chism, Newcomer, Ashby, and Mort. The National Survey of School Finance had meanwhile collected a large amount of information concerning the levels of school expenditure, the systems of State support, and quality of programs.[44] These data were used in defining the scope of defensible national foundation programs of education.

In 1936 and 1937, the National Education Association and many educational organizations supported the Harrison-Black-Fletcher bill involving a $300 millions distribution of Federal aid for general education with a minimum of control. Extensive hearings were held in both houses, but because of the unfavorable state of Federal finances the administration took the position that no new commitments should be made without the levying of new taxes.[45] H. R. 5962 authorized $100 millions annually in grants, to be increased $50 millions each year until the sum of $300 millions was reached. The funds were to be distributed on the basis of census population aged 5 to 20, with few limitations on the manner of expenditure. The only requirements were that a minimum term of 160 days be maintained; that a just and equitable distribution be made among public schools; that the State continue to spend as much per person aged 5 to 20 as was spent in 1936; that reports be submitted on work done; and that Federal audits be made.

The administration and several educational groups opposed apportionment solely on the basis of school population, favoring distribution according to financial need as a more desirable means of guaranteeing a minimum standard of educational opportunity. Others believed that the appropriation was inadequate, that the bill did not guarantee removal of race discriminations, or that it would be prejudicial to parochial schools. Some wanted more Federal discretion and control, others feared Federal control would develop. Still others felt that efforts should first be made within States to consolidate small school districts, equalize opportunity, and levy taxes comparable to those of other States. The National Education Association and the Farm Bureau Federation, however, felt that the bill at least established the long-sought principle of general Federal aid, and that, while not fully equalizing opportunity, it did yield some equalization, since the ratio of Federal funds to State funds was higher in States of small expenditure (South) than in those of large expenditure.

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[43] Ibid., p. 474.

[44] Ibid., pp. 474–475.

[45] U. S. Congress, Senate Committee on Education and Labor, Assistance to States and Territories in Providing Programs of Public Education, Hearings on S. 419, 75th Cong., 1st sess., 1937, Feb. 9–15, 1937. U. S. Congress, House of Representatives, Committee on Education, Federal Aid to the States for the Support of Public Schools, Hearings on H. R. 5962, 75th Cong., 1st sess., 1937.

In 1935–36 similar bills were introduced to guarantee annual Federal aid of $25 per public-school pupil ($700 millions annually).[46]

In 1938–39, the Advisory Committee on Education completed an exhaustive survey of the subject of Federal support. It recommended a program of general aid, allocated according to an index of need based on children of school age, and an index of financial ability. A 6-year aid program was visualized as expanding from $72 millions in 1939–40 to $202 millions in 1944–45. After such a period, the program and the relations worked out with the States would be reexamined. In general, educational administration, content, and processes would be left to the States, and no Federal control would be exercised over courses of study or methods of teaching. The only Federal checks would be to safeguard funds. This report took a stand against the existing formulas of stimulative aids to selected activities, but did admit that some earmarking of Federal grants was required. Reward-for-effort aids might be continued to some degree after steps were taken to assure a defensible minimum program in all States. Special aids could be disposed of after they had served their purpose, and the general aid program would make this possible. With a more adequate foundation program, it was believed that smaller aids would be as stimulative as larger aids had been in the past, and that the distortion of State and local finances in order to provide matching funds for specially aided functions, would be avoided.[47]

The National Resources Planning Board has included educational equalization and rural school construction and district consolidation in its discussions of post-war public-works planning.[48]

General Federal-aid bills continue to be introduced, including many connected with the defense emergency. S. 1305, Seventy-sixth Congress, for example, would have distributed grants ranging from $75 millions in 1940 to $208 millions in 1945. Basic elementary and secondary school aid would be accorded on the basis of annual census estimates of children 5 to 19, each rural child being weighted 1.4 to adjust for sparsity. The most important aspect of this bill was its provision for an objective index of financial ability to be developed by the Secretary of the Treasury, using the yield of a uniform tax plan, or comparable economic indices, to avoid the discretionary elements of direct estimates. In addition to general elementary and secondary school aid, the bill would extend lesser amounts for teacher preparation, building construction, State department administration, adult education, rural libraries, cooperative educational research, and education of Federal reservation children. The bill follows the general pattern outlined by the Advisory Committee on Education.[49]

4. PROBLEMS OF MEASUREMENT AND TECHNIQUES IN FEDERAL AIDS FOR EDUCATION

Technical difficulties in the measurement of financial ability are very great, but the refinement of Federal measurements of State need and ability has assumed much more importance than it deserves in view of the overshadowing problems of equitable State-local distribu-

[46] Cf. H. R. 6360, 74th Cong., 1st sess., March 4, 1935.

[47] Advisory Committee on Education, The Federal Government and Education, Washington, 1938, p. 28.

[48] National Resources Planning Board, The Development of Resources and Stabilization of Employment in the United States, January 1941.

[49] U. S. Congress, Senate Committee on Education and Labor, Federal Assistance to the States for the Support of Public Education, Report on S. 1305, 76th Cong., 1st sess., 1939.

tion of funds, equalization by local area enlargement, and the quality of the educational offering. No great inequity would result from the use of even such simple measures as children of school age and per capita income in the distribution of equalization aid. This does not mean, however, that effort to improve the measurement of need and ability should be abandoned.

5. CONTROLS

(a) State equalization plans and redistricting.

To realize the objectives of a national minimum foundation program, intrastate equalization plans must be developed, including the basic equalization device of district enlargement. If a State employs per capita distributions or matching grants, the purpose of Federal variable grants may be defeated, or disparities in educational offering may be intensified. In many States, the proportion of equalization grants must be increased and per capita and other distributions lessened to achieve the objectives visualized by Federal aid proponents. The Advisory Committee on Education conceived of a joint agreement between strong departments of education and the United States Office of Education concerning the plan of distribution of Federal grants within the State.[50] Possibly Federal approval of the State distribution system should be a condition of Federal aid. This would not necessarily mean that a uniform plan would have to be adopted by all States. It would mean that the plan used for distributing both State and Federal funds should be approved in the light of the Federal objective of equalizing educational opportunity.

With but few exceptions, existing State-aid systems give some degree of emphasis to the equalization of educational opportunity. The most prevalent faults are that equalization plans have been appended to older per capita plans of distributing aid which were not designed to equalize, and that the equalization funds do not constitute a sufficiently large proportion of total State aids. In other instances, the equalization plan itself is faulty.[51] Complete lack of an equalization program is due to the inertia of tradition or constitution provisions which prevent or prohibit such distributions.

Most States employ several types of broad State-aid distribution and a number of special funds, although the trend has been steadily toward the reduction of large numbers of special funds and the consolidation of State aids, with a view to guaranteeing a minimum foundation program of State support and equalizing educational opportunity.

If part of the State aid is distributed on a per capita basis and part on an equalization basis, and the local units are charged with the per capita funds in determining the amount to be distributed from the equalization funds, the entire distribution can be made to conform to the equalization objective. However, if per capita funds are unduly large compared to the equalization fund, so that substantial numbers of units are prevented from sharing in the equalization aids, the

[50] Advisory Committee on Education, Report of Committee, p. 197.

[51] As in the case of failure to equalize local assessed values in computing local contributions at a uniform tax rate or through setting the uniform tax rate at too high a level.

objective of equalization of educational opportunity may be thwarted. The foundation program may not be impaired if the per capita fund is extremely large, even though the equalization fund be small. The smaller the total State-aid appropriation relative to the total cost of school operation, the greater the need to distribute State aids on the small-fund equalization basis, if a defensible minimum foundation program is to be guaranteed to all districts.

The effectiveness of State-aid system in equalizing educational opportunity cannot be measured accurately in view of the lack of detailed information on differences in local taxpaying ability and burdens of school support. A study of the Advisory Committee on Education endeavored to determine whether State educational aid funds were distributed to produce a substantial degree of equalization of opportunity and whether distributive plans were designed to make the burdens of financial support relatively equal among various local units. If those counties with low planes of living, high ratio of children to adults, and relatively small assessed values per child did not receive larger amounts of aid per child to be educated, the State-aid system was not considered adequate.[52] Sample counties in 26 States were examined with reference to estimated planes of living,[53] ratio of children aged 7 to 13 per 1,000 adults aged 20 to 64, and dollars per child which might be raised by a ten-mill tax on assessed valuation. It was concluded on this very crude basis of county (not school district) sampling that State-aid systems were not providing equal opportunity for rich and poor counties.

In 2 of the 26 States, the amount of State-aid funds was so small that practically no equalization could result from distribution (Colorado and Nebraska). In two States where funds per child aged 7 to 13 were more than $30, the richer and more able counties actually received more State aid per child aged 7 to 13 than the poorer and less able counties (Arizona and New Mexico). In 1939–40, Arizona State-aid funds accounted for 18 percent of all school costs, and 96 percent of this State aid was distributed on a straight per capita basis. In three States, with relatively small distributive funds, the richer counties received practically the same amounts per child as the poorer ones (Idaho, Kentucky, Maine). A negligible amount of equalization results from distribution of a small fund on a per-child basis over an entire State. While a large number of States with only moderate-sized distributive funds had begun to equalize educational opportunity and burden, the poorest counties got smaller shares of the aid funds than was considered socially justifiable. In fewer than one-third of the States did equalization plans provide a reasonably equitable distribution of aid to counties of greatest need and least ability, through distribution of larger shares to the weaker sections (as in Minnesota, Utah, West Virginia, Wyoming), or by large appropriations to all districts (Washington and Florida).[54] The study did not cover a number of States that already have extensive equalization plans or

[52] Advisory Committee on Education, The Extent of Equalization Secured Through State School Funds, Staff Study No. 6, Washington, D. C., 1938, pp. 1–5.

[53] Using the number of Federal tax returns, number of residence telephones, number of family radios.

[54] Advisory Committee on Education, The Extent of Equalization Secured Through State School Funds, p. 17.

heavy State support of the minimum program (California, Delaware, New York, Ohio, Indiana).[55]

Although there is an increasing number of exceptions, the majority of States are not, at present, distributing their own funds in a manner that could be recommended for the distribution of Federal funds. If the Federal Government should adopt the policy of granting aid to the States for the purpose of equalizing educational opportunity, it would seem that some precaution should be taken to insure an equitable distribution of the funds with respect to geographical areas and population elements within the States.[56]

The following circumstances illustrate the wide range in systems of State support. For 1939–40, Oregon State-aid funds met only 1.7 percent of school costs, and all were distributed on the school census basis.[57] Iowa met a correspondingly low percentage of total school costs, preferring to earmark newer State taxes for property-tax relief through the homestead tax-exemption credit device. Texas met 51.7 percent of school costs with State funds, yet distributed $38.8 million of $48.3 million in State aid on the school census basis.[58] Delaware, on the other hand, met 93 percent of the total cost of schools with direct State support, and only a few districts participated in raising local funds for public education. North Carolina met 59.6 percent of school costs by State aid, distributing $24.8 of $26.2 millions in total aid on the basis of need determined by the State school commission.[59] About two-thirds of the States still meet less than 30 percent of school expenditures from State-aid funds, and the majority continue to cling to the early forms of per capita distribution [60] for basic aid, or combine this and other flat distributions with small equalization funds.

Growth of State-aid systems by accretion and patchwork amendment has caused a frequent lack of balance in methods and principles of support, which will require revision if Federal-aid funds are to be properly distributed. Within States, the rural-urban cleavage has often been responsible for relatively slow adoption of equalization as the basic principle for State aid, just as sectional disputes have tended to bar its acceptance in the field of Federal aid.

In 1939, of some 161,096 taxing units, exclusive of States, 118,667 were school districts. Some additional units perform both school and other functions, making altogether about 127,000 separate and independent school districts and other local school jurisdictions.[61]

These data illustrate the highly decentralized character of the school function. Some reduction in the number of school districts has

[55] Maryland State-aid funds covered 26.1 percent of total educational costs, utilizing a small equalization fund, together with per capita distributions and grants for tax relief. The small-fund equalization was made more effective through the use of only 23 county and 1 city administrative units, and high educational standards were made a part of the foundation program. The smaller the number of districts the more effectively the State may function as an equalizing agency. Some State-aid systems, such as that of Illinois until 1939, actually encourage retention of small districts by the use of flat minimum grants and guaranty of a fixed sum of computed property-tax yield and special State aid. Even after 1939, the Illinois system still placed greater emphasis on flat distributions not related to needs or ability than on equalization. Equalization aid constituted only about one-third of the distributive fund. With flat grants reduced in importance and attention paid to actual school services (foundation program) rather than mere monetary expenditures per school unit, a smaller State-aid fund would bring about a greater degree of equalization. (S. E. Leland, State-Local Fiscal Relations in Illinois, University of Chicago Press, 1941, p. 106.) A further and common fault lies in failure to use properly equalized local assessed values as the basis for computing the local contribution at a uniform tax rate.

[56] Advisory Committee on Education, The Extent of Equalization Secured Through State Funds, pp. 18–19.

[57] National Education Association, School Finance Systems, Series 1, State Systems: Elementary and Secondary Schools, *Oregon*, revised, June 1941, National Education Association, Washington, 1941, p. 2.

[58] Ibid., *Texas*.

[59] Ibid., *North Carolina*.

[60] School census, school enrollment, or average daily attendance. The per capita plan has no specific objective in terms of cost of a defined foundation program.

[61] Advisory Committee on Education, Report of Committee, p. 10.

been occurring, but progress in this direction is slow. Some of the largest numbers are found in the more financially able States such as Illinois, New York, and Michigan, while several of the poorer Southern States have small numbers of districts, utilizing the county-unit system. Office of Education studies in 10 States, made in cooperation with State departments, have suggested a material reduction in the number of districts. In Arkansas, for example, it was suggested that the number be reduced from 3,134 to 75.[62]

Small neighborhood districts, sometimes with 100 families and a tax base as small as $100,000, are lauded for their "democracy," but they frequently cannot afford to adopt modern techniques and have little professional guidance. Even if liberally supplied with outside funds, equipment, teaching personnel, and professional guidance might be wastefully utilized for small enrollments. Complete high-school programs, including vocational training, for enrollments as small as 100 are quite uneconomical. One prevalent fault, which runs counter to the equalization aim, is the segregation of utility and railroad assessed valuation for the exclusive taxation of the particular small districts in which they happen to be located. As a matter of fact, many small enrollment districts have been intentionally organized to include such property and operate at a low tax rate, while neighboring units must support schools by taxing farm or residential property alone at high rates.

The furtherance of the equalization principle and conservation of Federal and State funds by district enlargement suggests that one of the more fruitful fields for Federal aid would be in school construction, perhaps conducted in conjunction with the cyclical public works program.[63] School construction would be used to help realize whatever economies are involved in rural school consolidation and, more important, to reduce inequalities in educational offering. Recent public works school construction has not given primary attention to reorganization plans, since the purpose has been mainly the provision of employment, and the States had not all prepared the way with locally accepted plans of consolidation.

The rural population cannot be expected to assume the full cost of replacement of old school plants. Aid in rehousing rural schools offers one means of exercising Federal controls through minimum standards as to size of attendance units under different conditions, and would oblige the States to make surveys directed toward improvement of local school organization. Plans would be submitted for Federal inspection, and when the appropriate changes were accepted locally, aid would be granted. This field has the advantage of not being directly concerned with the content of the educational offering, since only the externals of plant and size of district are involved. An opportunity is thus presented to attack the more fundamental problem in the field, that of district reorganization, and to put to the test both the techniques, and the professions of willingness to deal with the problem if only Federal-aid funds were available. If appropriate results were achieved, in the direction of equalization by area enlargement and more adequate facilities, the balance of Federal aid for general school operation distributed on an equalization basis could be greatly enlarged.

[62] U. S. Office of Education, Local School Unit Organization in 10 States, Bulletin 10, 1938 (1939).
[63] Cf. National Resources Planning Board, Development of Resources and Stabilization of Employment in the United States, Pt. II, "Regional Development Plans," 1941, pp. 21, 51, 136, 164, et passim.

In view of State experience, it is not altogether certain that heavy Federal aid alone will speed up the process of local district reorganization and improvement of school systems, even though some of the poorer States appear to make above average efforts to modernize school administration. However, the point is also made that the problems of educational organization vary considerably from State to State, and that there is a wide latitude for difference in opinion and experimentation, which must be provided by local initiative. It is pointed out that cooperative studies of district reorganizations have already been made by the States and the Office of Education and might be continued, but without conditioning aid upon the adoption of any one plan that happened to be favored by the national agency. It would appear desirable that any Federal-aid program provide cooperative surveys of school organization for State development, and at least for consultation with the Federal Government concerning long-run programs of school reorganization and for the submission of reports upon the progress in realizing such programs.

(*b*) *Division between Negroes and whites.*

The existence of the wide racial differentials in educational expenditures in many States raises serious questions as to the effectiveness of Federal financial aid alone in equalizing educational opportunity. Undoubtedly latitude for Federal-State consultation and advice on this subject should be provided.

While the United States does not have the problem of voluntarily segregated language groups,[64] as in Canada, a serious problem of involuntary racial segregation is present in 17 States and the District of Columbia, which maintain separate schools for Negroes. The seriousness of this problem lies principally in the fact that in 14 States the Negro schools are operated at a substantially lower level of expenditure than white schools.[65] Fortunately, the differentials are gradually being narrowed.

In many Southern States, existing State-local expenditures per white pupil are two and one-half to three times the expenditures per Negro pupil. The results in the case of the Negro schools are a combination of poor buildings, lack of equipment, poorly trained and under paid teachers, short terms, lack of transportation, unusually large classes, lack of attendance enforcement, and few secondary schools. Local districts are allowed to divert State-aid funds, even those received on a per capita basis, from Negro to white schools. The 17 States [66] and the District of Columbia, in which segregated schools are maintained, contain 9,000,000 Negroes. The Negroes represent 23 percent of the population of these areas although they are only 8 percent of the population for the whole United States. The colored population amounts to as little as 6 percent of the population in Missouri, and as much as 50 percent in Mississippi.[67]

[64] Some American religious groups, maintaining separate schools, have opposed Federal aid to general elementary and secondary schools, as tending toward centralized control of the educational process, and as a further exaction of tax funds from those who already provide schools without benefit of public aid. The supporters of Federal-aid plans, seeking to minimize this resistance, have been inclined to stipulate that Federal-aid funds be available only to public schools, leaving the definition of "public" to the States. The States might define public schools as including parochial schools if they so desired.

[65] Doxey A. Wilkerson, Special Problems of Negro Education, Advisory Committee on Education, Staff Study No. 12, U. S. Government Printing Office, Washington, 1939, p. 49.

[66] Alabama, Arkansas, Delaware, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, Missouri. North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

[67] D. A. Wilkerson, op. cit., p. XV.

While expenditures per Negro pupil in the District of Columbia and Oklahoma are slightly larger than expenditures for white pupils, in Georgia, South Carolina, and Mississippi, average per capita expenditures for Negro pupils are only about one-fifth those for white pupils. For the 17 States and the District of Columbia, average current expenditure per pupil in average daily attendance (1935–36) was estimated at $20 for Negroes, $50 for whites.[68]

(c) *Other controls.*

One further question concerns the matter of educational objectives, a matter with which the advocates of local control and initiative are deeply concerned. Certainly no one would advocate a plan of national uniformity in the curriculum, but one may legitimately raise questions as to the clarity of present educational objectives, and the suitability of present educational programs to our needs. In too many States and localities, the reduction of illiteracy and the passing on of stereotyped bits of knowledge are the sole aim of the system. Training in practical citizenship; development of personal qualities, special skills, and aptitudes; and job training and vocational guidance, are not yet fully integrated in the program. Before spending billions of Federal funds for "more of the same," a job of appraisal of educational programs must be done in every State. The quantity and quality of education has been largely a responsibility of citizens of the local community, but the effects and the sources of funds are no longer purely local, and the appraisal and guidance of the program has become a highly technical matter. More State planning and direction than that involved in a few statutory prescriptions and mandatory laws will be required to clarify objectives. This process of planning educational programs might well be undertaken in consultation with Federal agencies, but if it is well done at the State level, Federal controls under Federal-aid programs need not develop. While the right to determine locally the kind of education children should be given may be regarded as essential to democracy, that right has been indifferently exercised. The right need not be surrendered for financial aid, but it could be vitalized and improved by the establishment of strong local districts and the use of technical guidance offered by State departments.

The correlation between ignorance, poverty, and other human ills is undoubtedly high, but the effectiveness of the existing school system in combating these problems is a matter of some doubt.[69]

6. FORM OF CONTROLS

Just how much coercion, as contrasted with persuasion, should be involved in Federal control is a debatable point; it is suggested that the latter would prove more effective in most cases. Perhaps the objectives of Federal aid might be stated in the preamble of the law, and a few minimum requirements, such as those relating to the length of school year and the auditing of funds, might be imposed as absolute conditions.

[68] Ibid., pp. 49, 52.
[69] Advisory Committee on Education, Report of Committee, pp. 206-208

7. AID FOR HIGHER EDUCATION

A considerable case can be made for the extension of the Federal-aid system to secondary and higher education. However, it may well be that Federal support for education at this level (or at least the level of higher education) should take the form of assistance to individuals, rather than to educational institutions. Federally supported scholarships of various sorts—grants, loan scholarships, work scholarships on the order of those offered by the National Youth Administration, and scholarships that are to be repaid through a return of a percentage of income received by the beneficiary over a certain period in his post-school period would be appropriate. The amount granted on these conditions should be generous, but the selection should follow rigorous standards of fitness. There is abundant evidence that large numbers of persons of superior capacity do not pursue their educations to the point which their own interest and that of the country require. A principal reason for this fact is economic, the financial inability to go on with their education. National interest in the development of talent is too obvious to require argument. A consideration sometimes overlooked is the fact that an abundance of trained and talented personnel, particularly in the professions, tends to reduce inequalities in the distribution of income. A precedent for Federal assistance to youth pursuing an education occurred during the depression of the thirties, and has survived in part to the present. This is the National Youth Administration grants. Though the techniques of this program can probably be improved, the idea of Federal scholarships for promising youth is a sound one, and should be retained and developed further.

That economic necessity is one of the principal reasons for leaving high school and college before graduation, and that much of the best talent of the country goes undeveloped, is a matter of voluminous evidence.[70] To cite a few of the findings only: The Wisconsin Association of Colleges and Secondary Schools examined cases of 16,619 high-school students in 1929. One conclusion was that "out of the 1,660 high-school seniors in the highest tenth were 450 who expressed no intention to continue, but for whom further academic training would be a good investment for society. If we include the two higher tenths there are 1,198 students who indicated no intention of going on to college but from whose further education society might profit greatly." [71] Economic factors are not the sole explanation of this situation, of course. Nor can it be assumed that schooling is the only form of education. Even granting these qualifications, the waste involved in the situation just described must be substantial.

A study in New York State, considering youths of equal ability, concluded that "while financial handicap does not bar a student entirely from advanced training, very few young people from homes rated low in economic resources continue their training beyond the secondary level." [72] Most striking of all, perhaps, is the contention that colleges in Ohio are drawing almost a "run of the mine" sampling

[70] Educational Policies Commission, National Education Association, Education and Economic Well-Being in American Democracy, ch. VI.

[71] Frank O. Holt, "Securing a More Highly Selected Student Body at the University of Wisconsin," Bulletin of the American Association of Collegiate Registrars, vol. 8, pp. 247-258.

[72] Ruth E. Eckert and Thomas G. Marshall, When Youth Leaves School, 1939, p. 160.

of high-school graduates.[73] Half of the best talent does not enter the abundant colleges of the State.

8. CONCLUSION

It can hardly be doubted that there is sufficient general interest in education to warrant its inclusion among those national minima which should be underwritten by the taxing power of the entire Nation. Federal aid, at least for elementary education on a conservative scale, can be strongly recommended. Every effort should be made to safeguard the interest of those who fear that Federal aid would mean regimentation and the suppression of minority views and wishes. But this need not mean that the Federal Government should shirk the necessary controls that general citizenship interests require. At least part of the distributed funds should follow a formula aimed at equalization and the maintenance of minimum standards of educational opportunity. There is so much logic and good sense behind this program that its eventual acceptance seems inevitable.

C. Highway Expenditures

1. BACKGROUND

Highway expenditures constitute a field to which major attention cannot here be given. It is a field too large to cover here with a proper degree of thoroughness; and it is a field in which intergovernmental relationships, though many and complicated enough, have been relatively satisfactory.

Modern Federal participation in the highway program on a substantial scale may be said to have started with the Federal aid program in 1916.[74] The participation has been consistently maintained and has grown substantially.[75] In addition, the Federal Government supports directly a very minor portion of highways, e.g., those through public forests.[76] Federal aid has been distributed mainly according to a formula[77] giving equal weight to area, population, and miles of post roads. The weights have been changed occasionally in distributions for specific projects.[78] Generally, matching has been required but exceptions during the depression of the thirties were common and have continued during the military period of the forties. Aids have generally been restricted to a primary system of highways, but in recent years secondary roads have also received Federal support.

The first objective of Federal aid was to promote an adequate transportation system particularly for through highways. With the de-

[73] H. A. Toppo, "Test and Techniques," Occupations, vol. 12, April 1934, pp. 20, 24.

[74] Under provisions of the Federal Aid Road Act of 1916 (39 Stat. L. 355). However, Federal interest on a minor scale was evidenced previously by the establishment in 1893 of the Office of Road Inquiry for road research and information (28 Stat. L. 264, 268) and the $500,000 appropriation for road improvement under the Post Office Appropriation Act of 1912 (37 Stat. L. 539).

[75] See such key highway legislation as 42 Stat. L. 212 (1922); 44 Stat. L. 1398 (1927); 45 Stat. L. 683 (1928); 46 Stat. L. 141 (1930); 46 Stat. L. 1030 (1930); 47 Stat. L. 709 (1932); 48 Stat. L. 993 (1934); 49 Stat. L. 1519 (1936); and 54 Stat. L. 295 (1941). For a synopsis of the development see S. Rept. 1275, 75th Cong., 1st sess., Investigation of Executive Agencies of the Government, appendix II.

[76] Other direct Federal highway expenditures include support for roads, highways, trails, etc., in national parks and monuments in Indian and military reservations, and emergency funds to repair flood, hurricane, or earthquake damages.

[77] First established by sec. 4 of the Road Act of 1916.

[78] For example, the act of June 16, 1933 (48 Stat. L. 195) gave a somewhat more important weighting to population.

pression came the additional and major objective of reemployment.[79] Undoubtedly the appropriations for secondary roads gave weight to both an interest in agriculture and property tax relief. Most recently military objectives have become predominant.

2. MATCHING AND DISTRIBUTION FORMULAS

The general requirement that the States match the Federal highway aids has been accepted as satisfactory in the main though there has been some contention that there should be more equalization and that the program expects too much of the poor States.[80] The present prevailing procedure is supported by the fact that States raise revenue for highways by the special and convenient tax mechanism, motor vehicle taxes. Moreover, the present distribution formula favors the sparsely settled States (though not all of these States are poor). The distribution formula can be plausibly criticized on the ground that it leaves out of account such factors as traffic density, topography, and other physical factors. Equal weight to the area factor in the formula is certainly open to question.[81] The formula has the great advantage, however, that it is objective and can be used without excessive "politics." Where Federal programs go beyond "highways for highways' sake"—for welfare or military objectives—there is strong ground for departure from the formula and this has been recognized.[82]

3. CONTROLS

From its inception the Federal highway-aid program has imposed a considerable measure of control, including the requirement that the administration of expenditure upon Federal-aid highways had to be directly in charge of the States. Some control over administrative machinery has been exercised, but it has been too weak to avoid a heavy political turn-over of technical staff. However, the control has made possible the enforcement of standards as to construction and management. The attempt in the 1934 Cartwright Act to impose upon the States the condition of no diversion of motor-vehicle-tax revenues for use for public purposes other than highway construction and maintenance,[83] seems to be an undue interference with the States' freedom to order their own revenue systems. Fortunately, the Federal antidiversion clauses seem seldom to have been invoked and they have been circumvented fairly easily. An excise tax on gasoline for general public purposes may not be the best State fiscal policy, but it is not so bad as to be ruled out by Federally imposed conditions.

4. URBAN INTERESTS

A conspicuous element in the distribution of highway funds, including Federal aids and the State revenues raised from motor-vehicle taxes, is the small proportion going to urban centers. The situation

[79] Report of the Chief of Public Roads 1935, p. 2; 1936, p. 5; 1937, p. 1; Charles L. Dearing, American Highway Policy, Brookings Institution, Washington, 1942, pp. 86 ff; Henry J. Bitterman, State and Federal Grants-in-Aid, Mentzer, Chicago, 1938, pp. 277 ff.

[80] For general appraisals, typically favorable, see: House Committee on Roads, Hearings, 67th Cong., 1st sess., May 1921, pp. 177–178; "Address of P. G. Hoffman before the American Association of State Highway Officials," New England Road Builders Association Weekly, 20:41, Oct. 11, 1941, p. 6; Address by H. G. Sours, American Highways, "Convention Number," 1941, pp. 14–15.

[81] For a more extended criticism of highway formulas see Henry J. Bitterman, op. cit., pp. 508–513.

[82] See, for example, the provisions of the Defense Highway Act of 1941, especially secs. 45, 46, and 47, or the earlier attempts to aid employment in the acts of 1932, 1933, and 1936.

[83] 48 Stat. L. 993, sec. 12. However, a clause limiting Federal deprivation to one-third of the apportioned amount due the State during the fiscal year, tempers this section somewhat.

is the more striking because of the very large part of total motor-vehicle traffic which occurs within the boundaries of cities.[84] However, the Work Projects Administration program of the depression period extended very substantial relief to cities in the form of work-relief projects on city streets.[85] As previously stated, an expansion of the urban share in the distribution of highway revenues is overdue.[86]

5. CRITICISM OF RESOURCE ALLOCATION

The importance of adequate transportation facilities in our modern era is generally conceded and highways afford fairly promising employment-creating public investment with prospects of self-liquidation through increased collections from motor-vehicle tax revenues. The ease with which highway revenues can be raised, added to the extensive Federal-aid program, insures a quite adequate proportion of the over-all budget devoted to highways. In fact there is some ground for apprehension that the proportion may be excessive.

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[84] In 1936, for example, 30 percent of all travel was estimated to be on city streets. "Public Aids to Transportation" (Eastman Report), vol. IV, p. 263.

[85] Well over $200 millions in the calendar year 1939.

[86] Federal concern with this problem is apparent: House Committee on Roads, Hearings on H. R. 8838 and on H. R. 7891, January and February, 1938; January, February, and March 1940; Senate Committee on Post Offices and Post Roads, Hearings on S. 3309 and H. R. 10140, January and May 1938, and on S. 3105, May 1940.

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[1] For materials in tables and charts, refer to List of Tables and List of Charts.

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