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ABSTRACT

The primary problem for American educational finance is not how to tax but how much to tax. In modern fiscal arrangements, States and localities extract resources from their citizens in some combination of sales, income, or wealth taxes. Any tax reform juggles the relative contribution of each source, but the total amount extracted is still the same. For those who wish tax reform, the issue is not the system of taxation, but the system of tax allocation. For example, this society must decide how much education is desirable relative to needs for roads or armies. Education should provide a foundation for political literacy. Because education invests in human capital, it should be pushed to the point at which investment in people yields the same return as investment in things. (RA)

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THE DILEMMAS OF STATE-LOCAL TAX REFORM

I. Summary and Introduction

Interested as you are in more money for better schools, you wish to reform state-local fiscal arrangements because, I presume, you believe that bad taxes prevent good expenditures. In addition, the reformer's itch is an incurrable though benign disease from which none of us is immune.

But I bring you a different view of the problem. Since the cost of public schools equals the private goods that must be given up to support them, the primary problem for American educational finance is not "how to tax" but how much to tax and spend. And the difference between a "good" and a "bad" tax system is nowhere near as large as is commonly supposed. Under modern fiscal conditions, states and localities must extract resources from their citizens through some rough and ready combination of income, sales, and wealth taxes. The combinations they use depend on economics, politics, and accident. To "reform" any of these combinations means to take the same sum from the same place or persons more efficiently and equitably. But since any change in taxes makes some people better off and others worse, we cannot say for certain that the group's welfare is improved.

Suppose, however, we take an existing state-local tax system, warts and all, and confront the citizen-taxpayers with some elegant alternative which, we claim, is better. How much on balance will they be willing to pay for the privilege of being taxed in a more expeditious fashion? The sum, I think, will be very small. Tax reform is small beer indeed; we should leave it and get on with the important business of deciding how much of our national income to invest in the formation of human capital.

II. Tax Systems: Origins

State-local tax systems emerge from a mixture of economic, political, and historical (accidental) forces. On the economics, all taxes come ultimately from income but their immediate objects are receipts, expenditures and wealth. That is to say, they are either income taxes, sales and consumption taxes, or property taxes. All other levies such as the gasoline "tax" are really user charges or prices. Try as he might, neither the ingenuity nor the rapacity of the taxgatherer can provide him with any other weapons than these.

The proportions between these levies, however, vary widely from one jurisdiction to another. Oregon, for instance, abominates the sales tax while Nevada prefers -- for some reason -- not to tax income. And the jurisdictions that use all three weapons, do so in many different ways, with the most varicolored patterns of coverage, exemptions, and comparative yield.

A. The Economics

The tax and the expenditure system of any jurisdiction reflects preferences, income, and comparative costs.

By far the most important differences among cities, states and school districts are their citizens' preferences for public versus private goods. Just as families differ in their desires for food, clothing, and amusements so communities differ in their preferences for schools, roads, welfare, and qualified but expensive public servants. Differences in income and costs also enter the picture.

So far as the data mean what they seem, these state-local variations are quite striking. In 1968, state-local taxes and user charges took 13.5 per cent of personal income in the United States as a whole. (Advisory Commision on Intergovernmental Relations, State and Local Finances: Significant Features 1967 to 1970.) But these fractions varied from a low of 10.5 in Illinois and 10.7 in Connecticut to a high of 19.1 in North Dakota and 18.6 in Wyoming. California stood at 16.1, Oregon at 14.1 and Washington at 14.9. Some of the high figures probably reflect the greater unit cost of public services due to population sparsity, as in North Dakota's 19.1 or Alaska's 17.0. (Price elasticity of demand must also have been less than unity). South Dakota, also afflicted with sparsity, spent only 15.8 per cent.

People select the places where they live and work partly on the basis of the tax-expenditure balance. Naturally, people prefer low taxes and generous public services but such Utopias are hard to find. Faced with marginal choices, therefore, some families elect a locality with good roads and schools plus high taxes while others select unreliable roads and miserable schools but low taxes. Others select something in between o that, in this way, choice ratifies the variations that chance created.

B. The Politics

Fiscal differences arise also from political choices and historical accidents.

Politicians wish to maximize their political power, subject to the constraint that they do not violate their ideological convictions. Thus they select the taxes that win the most, or lose the least, votes under the conditions of the time and place. In this way they court the favor or avoid the enmity of the citizens, who are both master and servant to them.

In making these choices they start with what they have, that is with a fiscal landscape strewn with the wreckage of past encounters and the buried bones of old enactments. Then they must identify the forces they serve or oppose and estimate the strength of each. Next they design a tax policy which appeals to those they serve or, at least, raises up no unnecessary enemies. Then they bargain at the council table with others who serve different interests or have different estimates. And finally in the arena of public discussion, they defend or conceal what they have done.

Small wonder, then, at the variations in fiscal patterns even when economic conditions -- preferences, income, and comparative costs -- are the same. The politics of each jurisdiction differ because of variations in (1) historical conditions, (2) political interests, (3) politicians' estimates of those interests, and (4) the conditions of implementation.

C. Schools and Taxes

Now to the question of why school taxes are what they are. As is well known, public elementary and secondary education in all the states derives its sustenance from a mixture of local levies on property plus state sales and income taxes disbursed as basic and equalization aid. The rationale for local property taxes is obvious: the wealth is available; the local tax collector can reach it whereas he cannot easily administer the other forms of taxation. A local system of income and sales taxes, moreover, would squash down the base on which it rests for jurisdictions whose rates were higher than their neighbor's;

the same happens to property but much less seriously.

What is not quite so obvious, however, is the peculiar combination of advantages and disadvantages which the property tax base creates for education when people -- acting through their representatives -- vote money for schools in accord with their preferences and their pocketbook. (1) Since the taxes they choose will be directly proportional to their number of children but inversely proportional to their property, the existence of prosperous but childless families tends to lower school taxes. (2) Since good schools enhance property, however, even those who do not use them will be disposed to support them to that extent. Even retired bankers and absentee landlords have an investor's interest in their local schools.

(3) Third, the widespread separation between ownership and residence gives the schools an enormous advantage because the owners of business property who live outside the district cannot vote to keep their taxes down. True they do have some interest in public education. But the people who live and therefore vote in the district have both an investor's and a consumer's interest in public education. Further, the smaller the school district the smaller is the probability that owners of its business property live and vote within its boundaries, so that the present system of district fragmentation, which promotes "taxation without representation," seems designed to maximize the school tax rate. (4) Alas for the schools, however, district fragmentation works in the other direction when we consider how people react to the indirect benefits of education: The education of other people's children benefits me because all of us vote in the same elections and participate in the same political dialogue. But the advantages of political literacy come from the informed choices of people both far and near, and cannot be achieved unless education is widely diffused. Therefore -- on this account alone -- no one is willing to tax himself and his fellow citizens for the education of those who live <u>only</u> in his immediate vicinity, so that small districts mean low taxes. For the small district therefore, the level of school taxes depends only on the balance between the tax burden and the direct benefits of education.

(5) Our final factor deals with the way these preferences are translated into action through the political process. As stated above, the professional politician maximizes his political power just as the professional entrepreneur maximizes his net returns. In voting for taxes as for everything else he seeks that combination of burdens and benefits which optimizes his support among his constituency and his colleagues. This is how representative government

in a democratic society translates individual preferences into social choices. But what about the government of local schools? It too is "political" because it deals with social choices, in an institutional framework, through a representative body -- the local school board. But board members are seldom full time professional politicians and often regard their office as a duty rather than an honor. As part-time amateurs they can express their convictions, ventilate their prejudices and ignore the wishes of their constituents with respect to the tax rate and to many other matters as well. In the short run, therefore, the schools may not respond to the wishes of the people quite so closely as some other parts of government. Not in the long run, however. School board elections and tax referenda must eventually prove decisive, so that the board that spends too much or too little, or spends it on things the people do not want, will finally be turned out of office.

III. Tax Reform: How

State-local tax reform entails both economic and political problems, and the central issue for both is that <u>any</u> change from existing conditions makes some people better off and others worse off.

A. The Economics

A change in policy increases social welfare, an economist would say, only it it makes one or more persons better off without making any one else worse off. The literature of welfare economics calls this proposition "the strong welfare criterion." So far as it goes it is both intuitively attractive and analytically rigorous but, unfortunately, sheds little light on the hard problems of social change which do entail improvements in some people's lot at the expense of someone else.

Tax reform illustrates. Recently both California and Oregon have made much ado about "property tax relief." The voters of Oregon last summer (June, 1969) considered a proposal to substitute a state sales tax for some portion of their local property taxes, while a well known California assessor proposed a constitutional limit to the property tax rate. Both measures lost, but the agitation remains. Now, if everyone in Oregon had the same proportion of the property tax base as he had of the sales tax base, he gains on the turns what he loses on the stretches and pays just as much under the one as he does under the other. (He chooses between these taxes only on the basis of their "excess burden," i.e., on the satisfactions he loses by being forced to rearrange his pattern of economic activities after the taxes change relative prices.) But of course everyone does not have the same share of both tax bases. The proposed substitution therefore improves the welfare of those who have a higher than average ratio of property to consumption, but worsens it for those who have a lower ratio. An economist can say nothing, repeat nothing, about the desirability of the net result inasmuch as the satisfactions gained and lost occur inside the heads of different people.

Only if the gainers compensate the losers and have something left over for themselves does the change clearly improve welfare. If such a scheme of compensation proves impractical, even though possible, again nothing can be said about the desirability of the end result.

The inability of economists to make definitive statements about welfare dampens their enthusiasm for any and all "reforms" that entail changes in the existing mixture of sales, income, and property taxes.

What about reforming the administration of the tax system? The local, often politically appointed, assessor is an attractive candidate for reformers of every hue and temper. His inadequacies and inconsistencies are notorious; eloquent fulminations against these wayward practices are the stock in trade of every writer on local finance. (I too, long ago, indulged in this sport to such effect that even now reprinted versions rise to haunt me.) Several questions, one obvious and one more basic, must be posed at this point. The obvious question is: since changing assessment practices requires an expenditure of resources, can we be sure that the object is worth the cost and do we know that this is the best place to start spending money? The basic question is: what are the given conditions of the problem; how many degrees of freedom do we possess; how can "we" (as either outside observors or concerned citizens) count on the same political process that produced the assessor to change him to something better?

B. The Politics

Changing taxes is a political act. Whatever its economic merits, the change must be politically possible, and the people who propose it must have some notion of how to translate the possible into the actual; otherwise the whole enterprise is bootless. Or, more accurately, energies and time could better be expended on other things.

Translating the possible into the actual, in turn, demands a careful evaluation of the interests that gain and lose. Then those that stand to gain must be informed of their opportunity, encouraged to pursue it, and rallied to the cause. Those that lose must be prevented from discovering the true state of affairs for as long as possible, discouraged from pursuing their interests, and turned aside. These are the means of the battle and they in turn have their means -- alliances, promises, threats, and maneuvers innumerable.

If one wishes to reform taxation by substituting sales for property taxes, as in the Oregon case again, strong support can be anticipated from the property owners, mild opposition from the unpropertied consumers, and strong opposition from the merchants. In addition, the voters of Oregon appear to have had a visceral reaction against sales taxes -- perhaps because they feared that small beginnings promised large endings -- and such feelings are a political force of great moment.

Also of great moment, I must add, is the influence of ideas. Quite apart from interests, ideas are a vital political force because men take them as their interests and pursue them more ferociously than any prospect of selfish gain. Thus, in the present discussion, a "good idea" about tax reform could become a standard to which many repaired. It could become politically effective even though its proponents had neither the skill nor the intent to make it so. It could, that is, if someone else took it up and carried it through.

Now I do not imagine that the Finance Committee of the National Education Association is interested in "tax reform" as an academic exercise. Instead, they hope it serves their larger interest in more money for better schools. But how do they intend it to nurture this larger end? By devising a good "tax scheme," an intellectually respectable pattern for tax revision, which when announced automatically gathers everyone under its standard! If so, they face a dry season. For their plan must be implemented; it must be translated into practical workable politics and lobbied through the legislatures. Otherwise it dies.

IV. What Difference Does It Make

"To call a situation hopeless," says Frank Knight, "is the same as calling it ideal." I have argued (1) that state-local tax systems result from a complex set of economic, political, and historical forces; (2) that economists can say very little about changes in taxation which represent an unambiguous increase in welfare; (3) that anyone who wants to "reform" the tax system faces a difficult political problem. Is this a counsel of despair? No indeed; it is a message of hope.

In developing this hopeful doctrine, I begin with some economic fundamentals. Afflicted with the universal limitation of scarce resources, a society with virtually limitless desires must make hard choices among many alternatives. It must choose between guns and butter, between the present (consumtion) and the future (investment), and between private goods and public goods. Since "the cost of any one useful thing is the number of other useful things that must be given up in exchange for it," the cost of public goods equals the private goods that must be given up in order to build and operate schools, construct roads, or maintain armies.

Next, the output of public goods cannot be determined by prices and markets but must be financed through collective contributions; the community must get together and agree on a method of paying for them. In a modern economy with vast chunks of the national income handled by the public fisc, methods of payment -- though variegated in detail -- are quite simple in outline and entail some combination of income, consumption, and wealth taxes. (In addition the government charges prices often under the nom de plume of taxes, for operating highways, licensing taxicabs or marriages, and -- sometimes -- delivering mail.) No modern central government tries to support itself by tariffs and excises, as the U.S. did during much of the ninteenth century, and no city council nor state legislature relies on salt taxes or fines on bachelors. Schools tax property and hope for a factory within their district boundaries, cities or counties tax property and transactions, while states tax income and consumption. The details are unimportant.

(In addition every lower unit of government tries to get money and avoid control from every higher unit while every higher unit attempts to exercise control and grant money for the lower units in a way that optimizes its political security.)

In sum, the important fact about taxes is that someone must pay the money to get the goods, and the difference between "good" and "bad" tax systems is not so vital as is commonly supposed. Let me suggest a conjectural experiment: Take an allegedly imperfect tax system which currently raises $1 million for a particular state-local jurisdiction; call this system A. Then confront this principality with alternative and presumably better systems B & C, raising the same revenue -- spent for the same objects -- in different ways. Then ask each citizen-taxpayer how much he would be willing to pay in order to substitute B for A or C for A; ask them also how much they would bid to retain A. If they are honest and take time to answer our questions, these sums equal the amount by which B or C makes them better off than A; or for other people they show A's superiority over B and C. The net sum, the excess of bids for B and C over those for A equals a money measure of the rise in welfare occasioned by the tax reform.

How large would this measure be? Let the existing tax system, A, be the usual helter-skelter mixture of property taxes with arbitrary exemptions, transactions taxes with imperfect coverage, and sawtoothed income taxes with moderate rates -- all administered with the inefficiency normal to that enterprise. Let the alternative systems be elegant variations on the basic wealth-sales-income theme -- but with no more administrative improvements than can be reasonably predicted for the time and place. I still would be much surprised if the net sum were very large. I would expect a 3 to 5 per cent improvement or a bid of $30 to $50 thousand in order to be taxed $1 million by the best of the reformed systems; I would not expect a 10 or 20 per cent improvement.

Despite the words lavished upon it by both theoreticians and practical politicians, tax reform is not a topic of first importance. The difference between a good and a bad state-local system is not that large.

What, then, is important? What is important is not how, but how much. How many public goods do we want and need in general, and how much education do we wish in particular. Considering it as a consumption good we want the right amount of education to provide a foundation for political literacy in a complex society. As a production good, education means investment in human capital and should be pushed to the point where investment in people yields the same return as investment in things. These are the vital matters of our common concern. All else is digression.