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In defense of the Articles of Confederation and the contribution mechanism as a means of government finance: A general comment on the literature

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Abstract. I attempt to dispel several widely-held myths regarding government finance under the Articles of Confederation, some of which were reiterated in Dougherty and Cain (1997). I defend the contribution mechanism as a method of government finance that is superior to direct taxation by the federal government, and present evidence contradicting the belief that revenue collections under the Articles were poor. A proper comparison is with alternatives at that time, such as state tax collections and the federal governments own tax collections under the new U.S. Constitution, both of which were lower than the collection rate from states under the Articles.

1. Introduction: The myth of government finance under the articles

In a recent article, Dougherty and Cain (1997) reiterate the widely-held belief that the state contribution mechanism for financing the U.S. federal government under America's first constitution, the Articles of Confederation, was seriously flawed. While this comment was spawned by their article, I wish to provide evidence against several commonly-cited criticisms of government finance under the Articles. The evidence for this paper is drawn primarily from my own research, but other authors such as Dwight Lee (1985, 1994) and Randy Holcombe (1991, 1992) have also published research that contains a favorable view the Articles, suggesting that they were a superior document to the U.S. Constitution. Let me begin by briefly stating the view that I wish to address in this paper.

> *The myth*: Because states were reluctant to pay the contributions assessed on them by the federal government under the Articles of Confederation, the federal government's finances were crippled, resulting in reduced public goods provision. This problem led to the eventual giving of the power of taxation to the federal government in the U.S. Constitution, which overcame this problem.

This myth is based upon several related propositions that need to be addressed one at a time. The first relevant proposition asserts that state contributions were poor under the Articles, a proposition that I will address first before turning to the other propositions.

2. The reality of government finance under the articles

The Articles of Confederation was in effect for over a decade before the U.S. Constitution became effective on 4 March 1789.[1] The Articles of Confederation was a much different document than the U.S. Constitution, most notably, the federal government was required to finance its activities through contributions from the states because it did not have the power of direct taxation.

Dougherty and Cain present collection rate data on several requisitions between 1781 and 1786, on which they state that collection rates ranged from 2% to 66%. Taking a broader view, the most comprehensive listing of requisitions and states' compliance can be found in Bullock (1979 [1895]). Aggregating his data over *every* requisition made by the federal government, the collection rate was approximately 50%. There is no question that with only half of the money requested being paid that indeed the absolute collection rate of the federal government was poor under the Articles.

However, suppose that someone told you that they held stock in the XYZ corporation and that it earned a 2% rate of return in 1949. They also tell you that they now own an alternative stock in the ABC corporation, and that in 1996 it earned a 6% rate of return. Would you conclude that the 1949 investment in the XYZ corporation was a bad investment? Would this evidence be sufficient to conclude that the rate of return on XYZ in 1949 was low?

As economists, we are trained to look at opportunity costs. What matters is not the absolute amount of the return, but how large it is compared with other alternatives present at that time. Thus, the above information is not sufficient to make the claims that the 1949 XYZ investment earned a low rate of return. For example, suppose that the market rate of return in 1949 was only 1%. Now the investment appears to have earned a high rate of return relative to the alternatives at that time. This is the logic I wish to follow in an attempt to dismiss the widely held belief that the collection rate under the Articles was poor.[2] The fundamental error in logic is due to the conclusion of poor collection under the Articles being based on a comparison with the collection rates the federal government receives today from its direct taxes on citizens.

First, the technology of tax collection is the late 1700s was much different from what is present today. Studenski and Krooss (1963) mention that both during colonial times and under the Articles, state-level taxes were only paid by the patriotic and conscientious, with widespread evasion and inefficiency. States collected significantly less than 50% of the taxes that they levied on their own citizens. *Thus, the collection rate experienced by the federal government from state requisitions was higher than the collection rate the states were experiencing on their own taxes*.

Second, the first federal direct tax under the new U.S. Constitution was levied in July 1798 on population, house values, and land. As of 1801 only half of the total amount due had been collected. The collection rate was in fact so poor that President Jefferson did away with all direct taxes on citizens in 1802. They were reimposed for a few years during the War of 1812, but collection rates never exceeded 50% and the tax was repealed in 1817. The federal government did not again levy direct taxes on citizens until the Civil War, when the technology of collecting taxes had significantly progressed and the Commission of Internal Revenue was established to administer the collection of taxation. If one were to combine the total revenues from these first two attempts at direct federal taxes on citizens, the federal government's collection rate on its own power of taxation was less than the collection rate from states under the Articles. *Thus, had the federal government had the power of direct taxation under the Articles, and had they levied the same amount of taxes as they did requisitions, they would have probably collected less revenue*.

Many researchers provide quotations from politicians during the period surrounding the writing of the U.S. Constitution that criticize the collection rate under the Articles, and use this as a reason for giving the federal government the power of taxation. Researchers usually end at this time, however, and fail to look at what actually happened once the federal government did acquire the power of taxation.

Two main points need to be established concerning the collection rate under the Articles. First, while the collection rate was low in absolute terms, the appropriate comparison is with alternatives at that time, and in fact the collection mechanism was better than these alternatives. Second, there have been massive changes in the technology of collecting taxes since the 1700s. One cannot use data from this period to infer what might happen today under a system like was present under the Articles. I will address this issue in a later section.

An important and related point is that just because the federal government was given the power of taxation under the new U.S. Constitution does not mean it was a better system of raising revenue. Based on an analysis of the personal interests of the Constitution's writers, Beard (1935) concludes that the main reason delegates wanted to give the federal government the power of taxation was to ensure the government's repayment of the debt that the delegates and their constituents were holding. Thus, simply because the federal government currently has the power of taxation, and that the current system was adopted over the alternative, does not mean that it is a more efficient, nor a social-welfare enhancing, system of taxation compared with the one present under the Articles. It simply means that the writers of the Constitution *thought* that giving the power of taxation to the federal government would further their own interests.

3. Were government public goods underproduced?

In their article, Dougherty and Cain (1997) state that the federal government was producing public goods under the Articles, and that because of the free rider problem with the contributions, that these public goods were underprovided.

First, it is important to identify exactly what public goods was being provided by the federal government during this era. The answer to this is primarily the Revolutionary War. Thus, this argument, if correct, would imply that the Revolutionary War was underprovided. If it were true that the war was underprovided, it would have meant a lower probability of winning the war. This, however, is a claim that cannot be supported by fact. As a very small nation, America fought and won this war against the world's major superpower at the time. Had the U.S. lost the Revolutionary War, this claim might be given merit. Underprovision, however, might have been in the form that the U.S. could have won the war more rapidly and with few casualties. While this is a possibility, I have been unable to find a military reference on the Revolutionary War that criticizes the U.S. military's sufficiency in either number or strategy. In fact, the leader of the U.S. military forces was so popular because of his sufficiency in handling the war that he, George Washington, was elected the first President of the United States. Thus, the claim that public goods provision under the Articles was suboptimal lacks sufficient evidence in its favor from the Revolutionary War.

In his introductory paper to the volume in which the paper by Dougherty and Cain appears, Rowley (1997) mentions that the lack of revenue did, however, cause "serious problems for Congress in responding to British noncompliance with the 1783 Anglo-American peace treaty and to the Spanish blockade of the Mississippi River between 1784–1787." Thus, it is possible that some functions of government were hampered by low revenue, but as the previous section has established, it is not clear that if the federal government had the power of direct taxation, that its own direct levy of taxes would have provided any more revenue than did state contributions.[3]

4. Is the collection mechanism a viable means of government finance?

In their paper Dougherty and Cain state:

> Understanding what went wrong under the Articles is the first step toward understanding the constitutional design of other confederacies as well. If problems of state cooperation are inherent to other confederacies, then future unions will want to know which institutions make state and national interest coincide and which leave collective action unaffected. Unless requisition systems can be devised which provide adequate cost sharing among states, these systems should be avoided (p. 211).

Dougherty and Cain properly note that the problem with the Articles was in the enforcement mechanism for getting states to comply with federal requisitions. It is important to distinguish this from a criticism of the contribution mechanism itself as a means of government finance. I wish to address both of these issues.

The contribution mechanism is also frequently used in international organizations such as the United Nations. Throughout its 50-year history the U.N. has consistently received its contributions, although nations are sometimes late in their payments. Currently the U.S. is the largest debtor to the U.N. owing millions of dollars in delinquent contributions. The fact remains that the U.N. has been successful in collecting its contributions although it has no formal enforcement mechanism. This might suggest that if the state contribution mechanism under the Articles had remained in effect over a longer time horizon, that the problems with noncompliance might have been overcome. It is a well-established result that the prisoners' dilemma can be eventually overcome in a sufficiently repeated game.

Is a contribution mechanism superior to direct taxation authority? If one were to survey public choice econimists, and perhaps general citizens, about whether the U.N. should be given the power of taxation, the overwhelming response would be against this proposal. Almost every year since its inception, however, proposals that would allow the U.N. to have the power of taxation have been discussed within the organization.[4] Most troubling is that while most people believe that the U.N. should not have this power and instead should be financed with contributions, these same individuals believe that the U.S. federal government should have the power of taxation rather than being constrained to a contributions mechanism. These two arguments, however, cannot be separately sustained with any reasonable standard of logic. Any argument for why the U.N. should not have the power of taxation also applies to the U.S. federal government, and any argument for why the U.S. federal government should have the power of taxation also applies to the United Nations.

The most frequently cited reason that the U.N. should not be given the power of taxation is that it serves as an important constraint prohibiting the U.N. from engaging in massive world income redistribution. If this is correct, however, the same argument can be applied to the U.S. federal government. That is, had the U.S. federal government not have been given the power of taxation, it probably would have prevented the massive income-transfer orientation that characterizes the current "welfare-state" federal government. In his paper comparing the Articles with the U.S. Constitution, Holcombe (1991) concludes that the Articles were a much more constraining document than the Constitution. My argument is that the contribution mechanism itself provided a valuable constraint against redistributive activities that was removed in the new U.S. Constitution. While many people criticize the U.N. for not doing much, it is my own normatively-held belief that if the U.S. federal government did as little as the U.N. it would probably be a good thing.

As to the relative merits of financing a federal system of government with a contribution mechanism instead of allowing both levels to tax, previous research on this issue, such as Lee (1985, 1994) and Sobel (forthcoming), conclude that the contribution mechanism is strictly superior. Sobel (forthcoming) shows that allowing multiple levels of government to tax creates a common pool problem over the tax base, resulting in tax rates that are inefficiently high.[5] When either level changes its tax rate, it inversely affects the revenues of the other level of government. This intergovernmental revenue externality not only results in too high of tax rates, but also an inefficiency bias in government spending because of the systematic underestimation of the cost of taxation by government. In addition, because the federal government is constrained to levy equal tax rates across all states, while states can levy different rates, the Ramsey optimal tax rule implies that states can raise any given level of revenue with a lower excess burden than the federal government. Alternatively stated, for the same level of excess burden, states can raise more revenue than the federal government.

Some might be inclined to believe that the revenue raising potential of states is less than that of the federal government due to interjurisdictional competition. But under a properly structured contribution mechanism, all states would have to raise the additional taxes, and intergovernmental competition would come into play only with respect to how federal revenues are raised by the states. *In essence, the state contribution mechanism puts beneficial state-level intergovernmental competition to work in the collection of federal revenue.*

5. Proper enforcement mechanism in contribution systems

While the U.N. has no formal enforcement mechanism and it does a sufficient job of collecting its revenue, one might still believe that a system based upon contribution needs constraints to ensure the compliance of lower level contributors. Very little research has directly addressed this issue, however. Lee (1985, 1994) does discuss several other aspects of a properly structured collection mechanism, such as making sure that the contribution percents are set rigidly enough to discourage rent-seeking by the states to change their percentages. In addition, he notes that if contribution percentages were set as a fixed percent of state tax revenue, states would have an incentive to produce state government output at a lower cost in order to reduce their contributions to the federal government.

Regarding possible enforcement mechanisms, the most viable one that I have found comes from the organization of the Confederate States of America during the American Civil War.[6] During its early stages, the federal government of the Confederacy levied a 0.5% property tax to finance its war efforts. While the Confederate government did have the power to collect this tax directly from individuals, it gave states the option to submit revenues to the federal government instead of the federal government actually collecting taxes in the state.[7] States were allowed to raise the revenue any way they wanted, by imposing the property tax, by imposing another different tax, by using existing revenues, or by borrowing.[8] In addition, the Confederate government gave a 10% discount to states choosing the submit the revenues for their citizens, a discount significantly greater than the cost of collecting the taxes.[9] All but two of the states chose to pay the money directly, obtaining it by issuing state bonds or by imposing other types of taxes.[10] This was an effective mechanism, as the collection rate for this tax was almost 100%. This structure could easily be modified into a collection mechanism, under which if a state does not contribute, then and only then, can the federal government directly raise the revenue through taxation within the state that does not comply.

This is just on possibility. It appears very likely that if the federal government can design a system that currently fosters the compliance of more than 250 millin taxpayers, a system can be designed to foster the compliance of only 50 states.

6. Conclusions about government finance under the articles

This paper has attempted to dispel some widely held myths surrounding government finance under the Articles. At a most basic level, these myths were originated by historians who knew very little economics. These myths have been propagated throughout the literature on the Articles over the past 100 years without much change. I have attempted to show that the collection rate of approximately 50% under the Articles of Confederation contribution mechanism was, in fact, a very good collection rate. It was higher than the collection rate experienced by the states on their own taxes, and was higher than the collection rate that the federal government obtained on its own direct taxes after it was given this power under the new U.S. Constitution. In fact, it is very likely that had the federal government had the power of direct taxation, and levied the same amount of taxes as it did requisitions, that less revenue would have been collected during the Revolutionary War than was actually collected.

In addition, the argument that public goods were underprovided during this era is at odds with the evidence. The main public good being provided was the Revolutionary War, which not only was won against the world's superpower at the time, but military historians have not been critical of the adequacy of U.S. military tactics or sufficiency during the war. While other functions of government may have suffered as a result of the lower revenue, my argument is that had the federal government had the power of taxation, the evidence suggests that revenues would not have been any higher, and thus neither would have been government production.

Finally, a growing number of economists interested in this era of government finance (Dwight Lee and Randy Holcombe, most notably) have concluded that the Articles of Confederation and the contribution mechanism were a better form of government organization than in the U.S. Constitution. Lastly, if one wishes to be logically consistent, any argument for why the United Nations should or should not have the power of taxation is also directly applicable to the U.S. federal government.

Notes

1. The Articles of Confederation was passed by the Continental Congress on 15 November 1777, but was not ratified by the states until March 1781. Nonetheless, the Continental Congress' requisition authority over the states, given to them in the Articles, was first exercised on 22 November 1777. For a discussion of the workings of the Articles see Jensen (1940). Bullock (1979 [1895]) and Studenski and Krooss (1963) both give a detailed account of government finances during this period.
2. Some of the ideas presented in this section are based upon research contained in Sobel (forthcoming).
3. Note that the federal government were to rationally take into account the lower collection rate, it could have levied more taxes than they actually needed. This also would be true, however, for the federally set level of state requisitions.
4. For discussions relating to the system of U.N. financing, and suggested reforms, see Sobel (1994), Mendez (1992), United Nations (1986, 1992).

5. Another researcher, Flowers (1988), has shown that in the case of two leviathan governments allowed an overlapping power of taxation, the result will be a combined tax rate on the backward bending portion of the Laffer curve.
6. See Holcombe (1992) for an interesting comparison of the U.S. and Confederate constitutions.
7. Statute 3, Chapter 23, Sections 4 and 24, adopted in 1861 by the Provisional Congress of the Confederate States of America. For the full text of the statutes see Confederate States of America (1864). For a discussion of the finances of the Confederacy see Schwab (1901) and Smith (1901).
8. The U.S. Federal Government allowed states to collected the revenues for the tax bill of the War of 1812 and also in the Federal direct tax of 1861, see Smith (1901). States only collected the revenues, however, and did not have the flexibility to substitute to alternative revenue sources in these instances.
9. In Mississippi, where the federal government collected the tax, the cost of collection was less than 2%. The issue of economies of scale in tax collection, while never supported empirically, would not have been significantly present here as the C.S.A. federal government only collected this tax in two states.
10. Information on this subject from Smith (1901) and Schwab (1901).

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