A COMMISSION REPORT

LOCAL REVENUE DIVERSIFICATION:

INCOME, SALES TAXES & USER CHARGES

Advisory Commission on Intergovernmental Relations
Washington, D.C. 20575 • October 1974
A-47

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PREFACE

In this report, the Commission takes a much more positive view of local sales and income taxes and user charges than it had in its earlier consideration of this issue.

As a mechanism to diversify state-local revenue systems, local sales and income taxes — when equipped with necessary safeguards — are viewed as one of three approaches to achieve a more balanced use of sales, income and property taxes. The Commission fully recognizes that at any point in time choices will have to be made among the authorization of local sales and income taxes, increased state unconditional aid and state financial assumption approaches; nonetheless, in actual practice these devices can — and indeed are — pursued simultaneously.

Recommendation 1 presents the philosophy and safeguard conditions that should underpin the utilization of local sales and income taxes.

Recommendation 2 calls for Congress to authorize states to adopt a simplified approach to determining sales tax liability for firms doing business in a state where they maintain no physical presence.

Recommendation 3 urges the states to assist local governments in determining appropriate areas and rates for user charge financing.

Recommendation 4 deals with the issue of Federal withholding of local income taxes from Federal employees, an especially sensitive issue for the larger central cities.

These recommendations and the report were adopted and approved for publication by the Commission at its May 16, 1974, meeting.

Robert E. Merriam
Chairman

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This study was supervised by John Shannon, assistant director, taxation and finance. Staff responsibility was assigned to L. R. Gabler who prepared the report. The chapter on user charges was the responsibility of John Gambill.

The Commission and the staff benefited from an exchange of views with a wide variety of practitioners and academicians. These individuals included: Henry Aaron, Albert Alford, David Bain, William R. Brown, William Colman, Billy Cook, Stuart Connock, Phillip Dearborn, Laszlo Ecker-Racz, John Fava, Charles Goetz, Leon Klud, John Mikesell, Ramon Naus, John Peterson, Bill Stephenson, Frederick Stocker, Orba Traylor, Charles Waldauer, James B. Watts, Graham Watt and Joseph Weiss.

The frank exchange of views and the time afforded by these individuals is greatly appreciated by the Commission staff, which assumes full responsibility for the contents and accuracy of the report.

Wm. R. MacDougall
Executive Director

John Shannon
Assistant Director

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CONCLUSIONS AND RECOMMENDATIONS

It is necessary to consider once again the question of additional tax powers for the nation's general purpose local governments. More specifically, should states authorize *widespread* local use of income and sales taxes?

This issue poses a very real dilemma for federalists. On the one hand, our system of shared responsibilities, coupled with our tradition of strong local governments, argues in favor of a policy that would grant wide latitude to locally elected officials in selecting appropriate revenue instruments to underwrite the expenditure requirements of their diverse constituencies. On the other hand, widespread local use of income and sales taxes *without proper safeguards* could impair the revenue raising capability of the states, aggravate interlocal fiscal disparities, and pose serious compliance problems for many taxpayers.

PRESENT ACIR POSITION

The Commission's current position with respect to widespread use of local income and sales taxes can best be described as fairly negative — an inference that is supported by a review of the Commission's fiscal recommendations over the last decade.

- **1961** — The Commission observed that "the case for (local) non-property taxes is strongest in the large urban places. Even here, these taxes are best imposed cooperatively by a group of economically interdependent jurisdictions." The Commission also advised the states to impose certain safeguards on local non-property taxes. — *Local Non-Property Taxes and the Coordinating Role of the States.*

- **1962** — The Commission advocated repeal of *all* constitutional and statutory restrictions on local property tax powers. — *State Constitutional and Statutory Restrictions on Local Taxing Powers.*

- **1963** — The Commission urged the states to reform the local property tax and set forth a detailed agenda for property tax reform. — *The Role of the States in Strengthening the Property Tax.*

- **1965** — The Commission recommended that all states enact personal income taxes and urged Congress to allow Federal tax credits for state and local income tax payments. The Commission specifically stated that it "recommends taxation at the state rather than at the local level, but if local income taxes are also levied, they should be authorized only in the form of a supplement ("piggyback") to be administered with the state tax." The Commission also reiterated its 1961 recommendation with respect to other state imposed safeguards. — *Federal-State Coordination of Personal Income Taxes.*

- **1967** — The Commission advocated (a) Federal revenue sharing with states and their localities, (b) state use of both income and sales taxes, and (c) state financed circuit breakers to shield low income families from property tax overload situations. — *Fiscal Balance in the American Federal System.*

- **1969** — The Commission took the position that the national government should assume complete financial responsibility for public welfare and Medicaid programs and that the state should assume "substantially all" of the responsibility for the financing of public elementary and secondary education. — *State Aid to Local Government.*

- **1973** — The Commission underscored its earlier recommendations calling for the primacy of the state in the state-local fiscal picture when it concluded that "the interests of our federal system are best served when states retain primary responsibility for shaping policies dealing with general property tax relief and intrastate equalization of school finances." — *Financing Schools and Property Tax Relief A State Responsibility.*

To sum up, the Commission, to date, has consistently avoided a strong endorsement of local income and sales taxes while consistently endorsing a larger fiscal role for the states and (in a few instances) for the Federal government.

RECOMMENDATION 1

When Equipped with Proper Safeguards, Local Income and Sales Taxes Should be Viewed as One of Several Appropriate Means for Achieving a More Balanced Use of Property, Income and Sales Taxes.

The Commission concludes that our tradition of strong local government argues in favor of a state policy that grants wide latitude to local elected officials in the selection of appropriate revenue instruments to underwrite the expenditure requirements of their diverse constituencies.

The Commission reiterates its recommendation that calls on the states to assume gradually a larger share of the local school finance responsibility.

The Commission recommends that state governments permit general purpose local governments to diversify their revenue structures by levying either a local sales tax or a local income tax or both provided that the states take the necessary steps to insure the creation of a system of coordinated local income and sales taxes.

To achieve a coordinated system of local nonproperty taxes for general purpose local governments, the Commission recommends that states:

Safeguard 1: Uniform Tax Base

Provide a uniform local tax base which should conform to that of the state if the state imposes the levy.

Safeguard 2: State Administration

Collect and administer the local income or sales tax and designate or create a state agency to administer the local tax if the state does not impose such a levy.

Safeguard 3: Universal or Widespread Coverage

Encourage universal or widespread coverage by

(1) *mandating a minimum local levy and permitting counties and those cities with populations of at least 25,000 to choose a rate above this subject to a specified maximum, or by*

(2) giving first option to adopt the tax to the local government of widest jurisdictional reach with sharing provisions for municipal governments. The authority to adopt local sales and income taxes should also be extended to cities with populations of at least 25,000 if the larger unit of general government does not adopt the tax.

Safeguard 4: Origin Tax Situs

In general, use the point of sale rule for determining tax liability for local sales taxes and prohibit local use taxes on in-state purchases.

Safeguard 5: Constrained Rate Option

Permit local flexibility by specifying a range of tax rates that general purpose local governments may impose.

Safeguard 6: State Equalization

Minimize local fiscal disparities in those states characterized by a high degree of local fiscal responsibility and a fragmented local governmental structure by adopting an equalizing formula for the distribution of local non-property tax revenues among constituent units within the local taxing authority of widest jurisdictional reach and adopting new programs or using existing state programs of general support to offset fiscal disparities among local taxing authorities with the widest jurisdictional reach.

Safeguard 7: Income Tax Sharing

Specify arrangements for sharing taxes on earned income by non-residents between tax levying jurisdictions of residence and employment.

Several developments on the intergovernmental fiscal scene combine to justify a reexamination of the Commission's rather negative position with respect to widespread local use of income and sales taxes.

- *First, there is persuasive evidence that local taxpayers favor sales and income taxes over higher property taxes when confronted with the need to increase local revenue yields.* In a recent Urban Observatory Survey, citizens in ten large cities revealed a strong preference for a local sales tax generally by margins of 3-to-1 over higher property taxes. They also favored local income taxes over higher property taxes, albeit by less decisive margins.

If all taxes can be regarded as bitter medicine should not the local citizenry be allowed some voice in the selection of the least objectionable dosage?

- *Second, there is the steady growth of local sales and income taxes.* The revenue yield from these two local tax sources has risen from $1.1-billion in 1960 to $4.9-billion in 1972 — a 350 percent increase. Despite the rapid growth in local property tax collections, local sales and income taxes grew even faster — rising from 7 percent to 12 percent of the property tax take over these 12 years. These national aggregates fail to reveal the revenue significance of local sales and income taxes for individual jurisdictions.

It is not uncommon for one of these local non-property taxes to account for more than half of total tax collections and very frequently to produce 25 percent or more of the individual jurisdiction's tax collections.

Another indication of the growing diversification of the local revenue system is to be found in the fact that 26 states now authorize local sales taxes compared to only 13 in 1963. Eleven states now authorize either limited or widespread use of the local income tax. In short, the fiscal wind is to the back of the local non-property tax movement.

- *Third, local sales and income taxes are more responsive to natural economic growth and inflation than is the property tax.* Income and sales taxes "adjust" automatically to changes in wage levels and prices. By way of contrast, rapid inflationary periods require near herculean efforts by local assessors if their valuations are to be kept current.

- *Fourth, recent state experience — Virginia with its sales tax and Maryland with its income tax — clearly demonstrates that it is possible to avoid the pitfalls of the "unfettered,* *tax anything" approach, pioneered and pursued by Pennsylvania.* These safeguards include a uniform local tax base, state administration of the tax, and universal or widespread coverage of the tax. These safeguards virtually overcome two classic objections to local use of income and sales taxes — extraordinary taxpayer compliance cost and cutthroat interlocal tax competition.

• *Fifth, while critics of local non-property taxes have rightly centered their attention on the matter of fiscal disparities, there is no logical reason why this concern should extend to a virtual prohibition of local non-property taxes.* What is called for is state action to minimize disparities. Seemingly, a state equalization program that assures each local government sufficient revenues to finance a minimum package of services — a counterpart to the minimum foundation program in education formulas — with local governments permitted to go beyond this package if they should choose, would make the issue of disparities a secondary or even tertiary consideration.

• *Sixth, despite the growing use of income and sales taxes, most states still force the property tax to carry a disproportionate share of the total state-local tax load.* Currently the tax on property is producing approximately \$48-billion compared to state and local sales tax yields of \$24-billion and state and local income taxes of \$19-billion.

• *Seventh, there is increasing evidence that the Commission's basic solution for freeing up the property tax for cities and counties — state assumption of substantially all the costs of education — is, at best, a long range objective.* Virtually every time state policymakers suggest a quick takeover of the educational financing responsibility, they accompany this proposal with a promise to the electorate that they will impose effective fiscal lids on localities to insure dramatic property tax relief. In short, this type of property tax action — the imposition of property tax shackles for all units of local general government — is a nasty fiscal boomerang for cities and counties.

• *Eighth, there are alternative methods available to secure major property tax relief — state revenue sharing, "broad gauged" circuit breakers, and local revenue diversification.* By endorsing these alternatives, the Commission underscores that there is no uniform or single "boiler plate" ACIR prescription for the 50 state-local systems marked by widely varying traditions, needs, and attitudes toward the role that the state should play in local fiscal affairs. This is not to imply that the Commission is backing off from its fundamental objectives — diversified use of all three major revenue producers and the indispensable role that the state must play in bringing local needs and resources into tolerable balance. ACIR would recognize the need for a flexible state approach in selecting the means to accomplish these two fundamental ACIR objectives in a matter most compatible with the "centralist-decentralist" preferences of the 50 state-local policymakers and their constituencies.

• *Ninth, some would argue that there is an imbalance in the Commission's current prescription for fiscal federalism.* Up to this point, the Commission has consistently resolved doubts in favor of strengthening the position of the states. Now that there is increasing evidence that the states are becoming strong partners, it is particularly appropriate for the Commission to shore up its rather meager fiscal prescriptions for the local sector.

Local governments are becoming increasingly dependent on the states and Federal governments — cities now receive one of every three dollars of revenue from upper governmental levels while counties get more than 40 percent of their total general revenue from outside sources of finance. It may now be appropriate to suggest ways and means of helping local governments to help themselves. This concern is consistent with the Commission's oftstated philosophy — that federalism is strong only when all three governmental levels are strong.

The Case For Safeguards

Once the state embarks on a policy of widespread use of local sales and income taxes, it becomes imperative to face up to a series of issues raised by these tax instruments. Experience with local sales taxes in California prior to the Bradley-Burns Act and in Pennsylvania with local income taxes amply reveals the potential for chaos in unfettered and uncoordinated use of local non-property taxes. Because local governments constitute the most "open" of open economies, they are particularly sensitive to tax differentials between communities. Distortions in the locational decision of individuals and business, in shopping patterns, and in taxpayer compliance costs can all result from non-systematic utilization of local non-property taxes.

Safeguards 1-4 are specifically designed to deal with the administrative and compliance cost aspects of local non-property taxes. The overriding aim of these safeguards is to provide a high degree of uniformity among the local taxes and between local and state taxes. Adoption of a uniform local tax base that parallels the state base (if the state uses the tax), widespread or universal coverage of the population by the tax, state administration of the local tax, use of the point of sale, rather than customer location to determine tax liability and the prohibition of local use taxes on intrastate purchases can introduce a high degree of tax uniformity and transform these local taxes into instruments with some of the essential characteristics of a state tax. Giving local officials a choice of tax rates, within a specified range, will introduce some tax differentials. So long as these rate variations are not extreme, the price to be paid will not be great and local autonomy will be preserved and even enhanced. The state of Virginia on the local sales tax front and Maryland, and to a lesser extent Michigan, on the income tax side have clearly demonstrated that a high degree of uniformity can be built into local non-property taxes and thus make these smoothly functioning local tax instruments.

Equalization Safeguard

Widespread local use of non-property taxes also raises the necessity for states to adopt equalization programs to reduce potential fiscal disparities. The Commission has long recognized the need for state governments to pursue more vigorous equalization programs. It has called for equalization of property tax burdens and the introduction of fiscal and program-need measures for the distribution of state aids. Yet, the equalization issue remains timely. Progress in this direction has been slow, Serrano type decisions have spotlighted the problem and — more germane — local non-property taxes are likely to further emphasize taxable resource disparities.

In actual practice, only Kansas, Nevada, New York, North Carolina and Tennessee have moved on the equalization issue — and here only on the sales tax front among constituent units within a county, not among counties. Yet, redistribution programs among counties need not be particularly expensive to the state. If the state sector in Virginia, for example, had adopted a program to bring all below average yield jurisdictions up to the statewide per capita sales tax figure, while permitting all above average jurisdictions to retain their revenues, the cost to the state would have been only $18.4-million based on 1972 data. A comparable program in Maryland on the income tax front would have cost $28.3-million. In theory, equalization programs need cost nothing in additional revenues, if revenues from above average jurisdictions are redistributed to below average jurisdictions. There are, of course, powerful political obstacles to such drastic programs. Any number of compromises, however, can be worked out. Resource valleys can be filled in, a minimum foundation program for local governments can be defined, resource peaks can be shaved (but not totally eliminated), etc. All such approaches — and others as well — would serve to more closely mesh local needs and resources and reduce interjurisdictional disparities between the "haves" and "have-nots."

There is yet another reason for thinking that equalization programs need not be excessively expensive to the state. Many states already have the vehicle for implementing taxable resource equalization programs — their general support payments to local governments. Admittedly, most of these programs are too small in magnitude to make much present impact. But if they were placed on an equalization basis, these existing general support programs would reduce the amount of new money that the state would have to commit — though to be effective in combating the disparities problem, they would also have to be increased in magnitude.

Income Tax Sharing Safeguard

The intent of the income tax sharing safeguard is to explicitly recognize by state action the dual claims of areas of employment and residence to earned income of non-residents (salaries, wages, commissions, etc.).

This approach is based on the Michigan Uniform Local Income Tax Ordinance where places of residence and employment share 50-50 the earned income of non-residents. The present safeguard does not specify the sharing formula since this seems a matter best worked out at the state and local governmental levels, particularly in view of the fact that the 50-50 basis, while perfectly workable, is nonetheless an arbitrary determination.

The alternative to the principle of sharing also has legislative precedents. That is, local income tax revenues can be claimed wholly by the jurisdiction of residence (as in Pennyslvania, aside from Philadelphia) or wholly by the jurisdiction of employment (as in Philadelphia). Both such procedures amount to "beggar thy neighbor" policies. When the area of residence is the sole claimant, the income tax base of the central city is shrunk; when the area of employment is the sole claimant, the income tax base of surrounding jurisdictions (all of which need not be "rich bedroom communities") is reduced.

Recognizing the dual nature of the commuter, the sharing arrangement is the more attractive alternative. Since the non-resident does impose additional costs on the jurisdiction of employment and does derive some value from his employment opportunity, some direct tax contribution over and above that which may result from shifting of other taxes, is called for. Yet, the claim of the area of employment must be harmonized with the tax claims legitimately advanced by the area of residence.

RECOMMENDATION 2

Simplifying Interstate Sales Tax Liability for Firms Doing Business in a State Where No Place of Business is Maintained.

The Commission concludes that the more prevalent use of local sales taxes, coupled with variations in local sales tax rates, necessitates Congressional action to ease compliance problems for vendors in interstate commerce and to protect in-state business from the potential inroads of tax free competitors whose place of business is out-of-state. The Commission therefore recommends that Congress explicitly authorize the state government to impose a sales tax on firms making sales in states where they maintain no place of business and that the sales tax be equal to the state rate plus a single local rate. The Commission further recommends that the states adopt a formula to distribute the local sales tax portion among local governments.

The continued spread of local sales taxes coupled with variations in local tax rates (as called for in Recommendation 1) raises the issue of excessive compliance costs for firms transacting business in states where they maintain no place of business. To comply with existing law, each firm would have to subdivide its business activity by locality and then apply the applicable rate to this share of its total activity. Quite clearly, this requirement can become cumbersome at best as the mere collection of applicable local sales tax rates can be a considerable chore — particularly as the number of jurisdictions and rate variations is increased. It is seemingly impossible for all save the largest of enterprises.

Much of the difficulty arises in determining where the sale occurs — that is, who is entitled to the tax. The "pooling" approach is the simplest arrangement; under it, all sales made other than in jurisdictions where the firm has an actual place of business are taxed by the state at a supplementary local rate, and this amount returned to all local units on the basis of some formula.

The approach outlined here is based on the "Louisiana Plan" which has been incorporated in the Mondale Bill (S.2811). The principle of a uniform state-local sales and use tax rate has generated fairly widespread support. This would, in effect, overturn the Supreme Court decision rendered in the *National Bellas Hess* case and extend the states' sales tax reach to those firms doing business in states where they do not maintain a place of business.

This recommendation parallels the Mondale bill in calling for a uniform and simplified procedure to enable vendors to more easily comply with state and local sales taxes. For the purposes of this study, then, it resolves the difficulties created by increasing the number of local sales tax jurisdictions, each with some, albeit constrained, rate setting authority. This recommendation differs from the Mondale approach in that the latter would shrink the sales tax reach of those states that do not elect the "uniform state and local tax" as defined in the bill.

RECOMMENDATION 3

An Affirmative State Policy Regarding Local User Charges.

The Commission concludes that user charges constitute an effective method for diversifying local revenue structures when specific beneficiaries of particular government services can be readily or approximately identified.

The Commission therefore recommends that states:

Authorize and encourage local governments to adjust fees and charges annually to reflect at least changes in financial costs, and

Provide technical assistance and consultation as to appropriate areas, methods, and rates of charges.

There has been a steady growth in the fiscal importance of local user charges. Receipts from what the census calls "current charges" amounted to 17.1 percent of total city government revenue from all sources in 1971. In 1957, the corresponding figure was 12.7 percent. The parallel numbers for counties are 19.4 percent in 1971 and 15.1 percent in 1957.

The extent to which a local government makes use of a particular user charge and how much freedom it has in the choice of rates depends upon a state's constitution, statutory law, and case interpretations. Generally, localities are permitted to recover the cost of the particular service provided but may not use the charge to raise general revenue. Narrow interpretations of the law, of the service, or of costs may hamper effective local use of user charges. Furthermore, many charges recommended by researchers and technical experts may be viewed by lawyers as taxes. If the appropriate taxing power is lacking, the local government cannot charge the users. Thus, for example, a municipality may experience difficulty using parking taxes as a means of charging street users.

Although local governments are generally not permitted to use user charges and regulation fees as revenue, they are generally permitted to recover costs of associated activities. A combination of continued inflation and governmental inertia, can cause user receipts to lag far behind rising costs. One solution to this problem is to provide that all fees and charges be listed with the chief administrator. Once each year he should adjust such charges on the basis of changes in costs, with due allowance for an increase in productivity. In the case of inspections and the issuance of permits (very labor intensive activities), an increase in fees based on increases in the salary schedules is perhaps the simplest approach. And, rather than do nothing, charges should be increased on the basis of a standard price index.

In some cases, the state establishes (or places a ceiling on) the amount of a locally levied charge. This is particularly true of fees and fines imposed by constitutionally established offices. The state should also provide for regular adjustments of any charges which it controls.

A state agency could serve a valuable "clearing house" role for localities interested in modernizing their user charge systems. Meltsner, in his study of Oakland finances, reported that a decisive factor in the decision to impose a particular user charge was the extent to which such charges were used elsewhere.

Another state function would be the discovery of new areas for charging and new types of charges and to point out their relative strength and weaknesses.

Finally, on the basis of experience, the state agency can provide advice on the appropriate charges for existing services. Local officials who seek to increase revenue by placing greater reliance on user charges frequently encounter resistance from the members of operating departments who feel that they should provide a free or low cost service to the public.

Undoubtedly, the directors of many operating departments fear the scrutiny to which they might be subjected if their customers were required to pay a reasonable share of the costs of their service. Information about costs and proper pricing based on evidence gathered at large would act, therefore, as a check on individual department resistance.

Two intergovernmental issues concerning user charges are not dealt with by the recommendation. User charges are not included in the measure of fiscal effort for Federal revenue sharing but taxes are, thus discouraging the use of user charges and encouraging the use of taxes when a choice exists. State and local property, sales, income and gasoline taxes are deductible under the personal income tax but the other taxes and charges are not, thus influencing the choice between these alternative ways of raising revenue.

Four characteristics of a service should be examined in determining whether and how to charge for it.

Potential for Behavior Modification

Charging the user compels him to take account of the costs he imposes on the system. Sometimes his use will be very sensitive to the price charged but in other cases the amount of use is likely to be the same regardless of cost.

Nature of Benefits

Sometimes the users are too general or diffuse to be identified or the service exists to benefit someone other than, or in addition to, the actual user.

Feasibility of Administration

The cost of toll collectors, meter readers, inspectors, billing clerks and other enforcers may outweigh the waste that results from allowing unlimited use of the service or facility.

Equity

The equity of charging the proper economic price for a public service is analogous to charging the proper economic price for bread or milk. The more a person uses, the more he pays; as the costs he imposes on the system increase, the amount he pays increases. However, most charges are somewhat arbitrary and a few are highly regressive head taxes.

On these criteria some common user charges might well be called into question. For example, trash collection charges that are based on the measured *amount* of trash tends to encourage burning, littering, and dumping on vacant lots (the last a fire hazard). This approach fails because it neglects the interest of the population at large in discouraging such practices. On the other hand, trash collection charges which are not based on the amount of trash are user charges in name only and become regressive head taxes. This approach has no potential for behavior modification, makes minimum users pay as much as major users and takes a larger portion of the income of the poor.

Examined on the above criteria, the present policy of financing roads and city streets in part from property taxes (and other taxes unrelated to road use) has several undesirable effects. From the viewpoint of efficiency, the most satisfactory situation will prevail if drivers are compelled to take account of (by paying for) the costs of providing the road and the congestion costs (value of time lost) that they impose on other drivers. Not only does subsidization of roads from the property tax encourage overuse of motor vehicles, it also undetermines the economic viability of other forms of transit, thus eventually requiring subsidization of mass transit to restore parity. From the viewpoint of equity, drivers not property owners impose costs on the city through use of roads. Because many drivers do not even own or rent property in the city where they drive, a method for charging them would be especially desirable.

Several methods of charging for roads have been advanced by various writers. They include tolls at strategic access points to the city or to its most congested sector, local gasoline taxes, parking taxes, requiring permits to drive in the densest sector during rush hour, and perhaps in the future direct metering of the amount of use.

RECOMMENDATION 4

Federal Withholding Local Income Taxes.

The Commission concludes that Federal withholding of local income taxes from Federal employees will strengthen both the administration and effectiveness of local income taxes. The Commission therefore recommends that Congress enact legislation requiring the Federal government at the request of the local government to withhold local income tax payments from Federal employees who either reside in, or commute to, a local jurisdiction within the state.

Aside from voluntary agreements worked out between the Federal government and the cities of Lousiville, Philadelphia and St. Louis, cities cannot force agencies of the Federal government to withhold local income taxes. This is a particularly sensitive area for the large central cities with their heavy concentrations of Federal employees.

H.R. 8660, as passed by the House, would drastically alter this situation. This legislation, currently pending in the Senate, would authorize Federal withholding for all cities with 500 or more Federal employees. It would include the within state commuter but not the individual who lives and works in different States. This legislation would strengthen both the administration and effectiveness of local income taxes.

Chapter 2

STATE-LOCAL FISCAL SYSTEMS

A gradual but steady movement toward more diversified revenue structures — that is, a more balanced use of the three major revenue producers, income, sales and property taxes — emerges as a salient characteristic of the state-local sector. This movement reflects both the growing importance of the state sector in the overall state-local fiscal picture and the increased utilization of sales and income taxes by state as well as local governments.

By 1973, state governments raised 55 percent of total state-local taxes, compared to just under half (49.9 percent) in 1963. Although there have been year-to-year interruptions, the general trend since the 1950s has been toward an increasing state share. This growing state revenue share, in turn, reflects increased utilization of the sales and income tax fields — by new adoptions and tax rate increases — and the greater responsiveness of these tax instruments to economic growth. By 1973, 40 state governments made use of a broad based income tax, 45 of the general sales tax, while 36 states used both.

Revenue diversification also stands out as a gradual but steady development in local government revenue patterns. At present, more than 4,300 localities in 26 states impose a general sales tax while approximately 4,200 jurisdictions in ten states have adopted a local income tax. Since the late 1950s, local government revenues (excluding intergovernmental aid) for all local governments (cities, counties, townships, special districts and school districts) expanded more than threefold, from $17.9-billion to $57.5-billion in 1971. (See Table II-1.) Equally significant are the distinct shifts in the composition of local government revenue sources. Back in 1957, the property tax accounted for 69.3 percent of all locally raised revenue from own sources. By 1971, the property tax contribution had fallen to 63.8 percent. Both cities and counties have deemphasized reliance on the local property tax. Among cities, the property tax share fell from 57.1 percent to 48.1 percent; among counties, the comparable figures are from 75.0 percent to 64.3 percent.

Despite this movement toward greater state-local revenue diversification, there is considerable distance to be travelled before a "balanced" use of the income, sales and property tax is achieved. De-

Table II-1

Distribution of General Revenue by Sources For All Local Governments, Cities and Counties: 1957 and 1971

Revenue Source	ALL LOCAL GOVERNMENTS Revenue ($000,000) 1971	ALL LOCAL GOVERNMENTS Revenue ($000,000) 1957	ALL LOCAL GOVERNMENTS Percent Distribution 1971	ALL LOCAL GOVERNMENTS Percent Distribution 1957	CITIES Revenue ($000,000) 1971	CITIES Revenue ($000,000) 1957	CITIES Percent Distribution 1971	CITIES Percent Distribution 1957	COUNTIES Revenue ($000,000) 1971	COUNTIES Revenue ($000,000) 1957	COUNTIES Percent Distribution 1971	COUNTIES Percent Distribution 1957
Intergovernmental[1]	34,473	7,539	—	—	9,697	1,756	—	—	8,490	2,133	—	—
Property Tax	36,726	12,385	63.8	69.3	10,041	4,297	48.1	57.1	7,592	2,613	64.3	75.0
Income Tax	1,747	191	3.0	1.1	1,416	181	6.8	2.4	167	—	1.4	—
General Sales Tax	2,339	656	4.1	3.7	1,658	602	7.9	8.0	590	53	5.0	1.5
Current Charges:	9,819	2,536	17.1	14.1	3,579	954	17.1	12.7	2,293	525	19.4	15.1
Education	2,470	665	4.3	3.7	218	76	1.0	1.0	223	46	1.9	1.3
Hospitals	2,569	459	4.5	2.6	718	167	3.4	2.2	1,169	206	9.9	5.9
Sewage	1,034	219	1.8	1.2	805	181	3.9	2.4	56	9	0.4	0.2
Housing-Urban Renewal	621	280	1.1	1.6	247	97	1.2	1.3	—	1	—	*
Other	3,125	913	5.4	5.1	1,591	433	7.6	5.8	845	263	7.2	7.6
All Other General Revenue	6,872	2,098	11.9	11.7	4,184	1,495	20.0	19.9	1,165	292	9.9	8.4
Total Local Revenue (Excluding Intergovernmental)	57,503	17,867	100.0	100.0	20,378	7,529	100.0	100.0	11,807	3,483	100.0	100.0

[1] Duplicative Intergovernmental transactions are excluded.

* Less than 0.05 percent.

Table II-2

A Ranking of the States on Basis of Balanced State-Local Use of Personal Income, General Sales and Property Taxes: 1971-72

STATE	States receive 100.0 points adjusted to reflect degree of state-local use of personal income, general sales and property taxes[1]				State Taxes as Percent-age of State-Local Taxes
		Adjustments Based on Use			
	Total (adjusted)	Personal Income Tax	General Sales Tax	Property Tax	
Hawaii	99.1	—	—	-0.9	75.5
Kentucky	98.9	-1.1	—	—	73.6
North Carolina	95.7	-1.6	-2.7	—	74.4
Virginia	95.6	-1.7	-2.7	—	59.6
Pennsylvania	95.5	-0.1	-4.4	—	61.5
South Carolina	94.2	-5.8	—	—	75.7
Georgia	92.3	-6.9	—	(-0.8)	65.3
Arkansas	91.4	-8.6	—	—	74.3
Maryland	91.2	—	-6.9	(-1.9)	57.2
New York	90.8	—	-2.5	(-6.7)	48.4
Utah	90.5	-4.6	—	(-4.9)	64.0
New Mexico	88.7	-10.1	(-1.2)	—	80.1
Idaho	88.2	-3.7	-3.3	(-4.8)	64.8
Missouri	87.5	-4.3	-1.0	(-7.2)	51.9
Michigan	86.8	-3.2	-0.9	(-9.1)	59.2
Alaska	86.5	—	-13.5	—	68.4
Oklahoma	85.8	-10.0	-4.2	—	66.7
West Virginia	85.1	-7.2	-7.7	—	75.9
Louisiana	85.0	-13.3	—	-1.7	70.7
Alabama	84.9	-8.8	—	-6.3	74.7
Colorado	84.1	-5.2	—	(-10.7)	50.9
Rhode Island	82.5	-6.7	-1.7	(-9.1)	60.4
Minnesota	82.0	—	-7.9	(-10.1)	58.8
Illinois	81.9	-7.0	—	(-11.1)	52.5
Wisconsin	81.2	—	-5.9	(-12.9)	59.8
Arizona	81.0	-10.4	—	(-8.6)	60.2
Mississippi	80.8	-13.0	(-6.2)	—	75.5
Tennessee	79.3	-19.0	(-1.7)	—	62.2
Vermont	77.8	-2.2	-11.7	(-8.3)	61.1
Florida	77.5	-20.0	—	(-2.5)	62.5

(Cont.)

Table II-2 cont.

A Ranking of the States on Basis of Balanced State-Local Use of Personal Income, General Sales and Property Taxes: 1971-72

STATE	States receive 100.0 points adjusted to reflect degree of state-local use of personal income, general sales and property taxes [1]				State Taxes as Percentage of State-Local Taxes
		Adjustments Based on Use			
	Total (adjusted)	Personal Income Tax	General Sales Tax	Property Tax	
Delaware	77.2	—	-20.0	-2.8	79.3
North Dakota	76.1	-12.8	—	(-11.1)	58.1
Nevada	75.3	-20.0	—	(-4.7)	56.5
California	73.8	-6.8	-1.8	(-17.6)	47.9
Ohio	73.8	-10.1	-3.1	(-13.0)	48.4
Washington	73.5	-20.0	—	(-6.5)	64.3
Iowa	73.3	-5.8	-4.7	(-16.2)	53.1
Maine	72.5	-14.2	—	(-13.3)	57.1
Texas	71.7	-20.0	—	(-8.3)	57.4
Indiana	71.2	-7.9	-1.4	(-19.5)	50.5
Kansas	67.8	-10.8	-2.7	(-18.7)	50.7
Massachusetts	64.7	—	-14.6	(-20.7)	48.8
Nebraska	63.0	-12.2	-4.5	(-20.3)	46.2
Connecticut	62.7	-16.9	-1.6	(-18.8)	50.8
Oregon	62.0	—	-20.0	(-18.0)	50.2
Wyoming	60.7	-20.0	—	(-19.3)	55.2
Montana	58.1	-1.5	-20.0	(-20.4)	49.7
South Dakota	56.2	-20.0	—	(-23.8)	42.5
New Jersey	48.8	-19.4	-5.8	(-26.0)	39.8
New Hampshire	34.0	-18.0	-20.0	(-28.0)	42.2
Exhibit:					
Dist. of Columbia	97.0	—	-2.1	(-0.9)	—

[1] Penalty points are given for both underuse and overuse of state-local personal income, general sales and property taxes. States receive one penalty point for each percentage of state-local tax revenue under 20 and over 30 derived from each tax. Penalty points in parentheses are for overuse — in those cases where the tax produces in excess of 30% of state-local tax revenue.

Source: ACIR staff calculations based on U.S. Bureau of the Census, *Governmental Finances in 1971-72: State Tax Collections in 1972,* and unpublished data.

fining balance flexibly, as a revenue contribution of not less than 20 percent and not more than 30 percent of state-local tax revenue for each of the three major revenue producers, the predominant characteristics of state-local tax systems to emerge are an under utilization of the income and sales tax and an over reliance on the local property tax. (See Table II-2.) Indeed, the personal income tax falls in the 20-30 percent range for only nine states and is under utilized — that is, accounts for less than 20 percent of total state-local taxes in all the remaining 41 states; the sales tax is under utilized in 28 states and over relied upon (accounting for more than 30 percent of state-local taxes) in three states. In striking contrast, the property tax is over relied upon in no less than 34 States and under utilized in only four.

State Fiscal Roles

Although there has been an upward trend in the aggregate state share of state-local taxes, this state-local financing ratio differs markedly among the states. Three categories of states can be distinguished, reflecting this difference in the state-local ratio of public sector financing. A state dominant fiscal partner role was defined for those states where the state sector accounts for at least 65 percent of total state-local tax revenue. (See Table II-3.) A state strong fiscal partner role characterizes those states where the state sector provides between 50 percent and 65 percent of the state-local tax total. A state junior fiscal partner role exists where the state government contributes less than 50 percent of the total state-local tax revenue.

Both within — but more, significantly, among — these three categories of states are differences in the degree to which the state government pursues alternative revenue diversification policies. Three such alternative policies are:

- state assumption of a given public service;
- state financial support by means of either conditional or unconditional intergovernmental grants-in-aid; and
- state authorization of local sales and income taxes.

Although these are distinct state policies, it should be emphasized that they are not mutually exclusive alternatives. In actual practice, states pursue one or more of these policies simultaneously and the degree to which they do is reflected in the division of financial responsibilities between a state and its local governments.

That the states simultaneously pursue more than one of the three policies is readily apparent. While numerous expenditure categories can be suggested as potential candidates to be shifted away from local governments — education, welfare, health, hospitals, highways — it is the financing of public schools that is the "swing" item due to its heavy claim on local government financial resources. Twelve of the 13 states falling into the state dominant fiscal partner role, for example, provide more than 50 percent of local school costs and in ten of these states, the state share of local schools is nearly two-thirds or more. Eight of these 13 states also authorize use of local sales or income taxes while 11 provide at least some financial aid for general local government support. Because of their pursuit of these approaches, the average effective property tax rates in these states are distinctly lower than for the other two state-local classifications. The median property tax rate for the 13 states in the dominant partner role was 1.14 percent, with a range from .56 in Louisiana to 1.70 in New Mexico.

Those states falling into the strong state partner classification are distinguished from the above group by a lesser assumption of local school costs and higher effective property tax rates. None of these 28 states provides as much as two-thirds of local school costs and only six provide as much as 50 percent. The median effective property tax rate for this state classification is 2.04 percent, or 79 percent higher than in the state dominant system. Although these "strong partnership" states have not assumed the financing of the education function to the extent that the dominant states have, they have pursued the other two alternatives to reliance on the local property tax. Fifteen of the 28 States in this category authorize local governments to impose sales or income taxes and 27 provide at least some general support money for local governments.

State governments pursuing the junior fiscal partner role further extend this pattern. That is, the state share of total taxes falls to 47.9 percent (median) compared to 58.5 percent and 74.7 percent in the previous two groups. The state share of local school costs is 26.4 percent (median) as opposed to 37.3 percent and 68.4 percent for the other State patterns. Only one of the nine states falling in this junior partner classification — New

Table II-3

State-Local Fiscal Systems, Significant Features: 1970-71 and 1971-72

State	All State Taxes, 1971-72 Rank	All State Taxes, 1971-72 %	Percentage of State-local taxes from— State Individual Income Tax, 1971-72	State General Sales Tax, 1971-72	State-Local Property Taxes, 1971-72	Local Income Taxes, 1970-71	Local General Sales Taxes, 1970-71	Average Effective Property Tax Rates, Existing Single Family Homes With FHA Insured Mortgages, 1971	State as % of State-Local Revenue (From Own Sources) for Local Schools, 1970-71
				State Dominant Fiscal Partner					
New Mexico	1	80.1	9.9	30.7	20.7	*	0.5	1.70	74.5
Delaware	2	79.3	28.0	—	17.2	1.6	—	1.26	76.3
West Virginia	3	75.9	12.8	12.3[1]	20.8	—	—	.69	56.7
South Carolina	4	75.7	14.2	27.2	23.2	—	—	.94	68.4
Hawaii	5	75.5	23.3	29.5[1]	19.1	—	—	.92	96.8
Mississippi	6	75.5	7.0	36.2	22.7	—	—	.96	66.3
Alabama	7	74.7	10.9	23.6	13.7	0.3	6.2	.85	74.6
North Carolina	8	74.4	18.4	16.6	25.1	—	0.7	1.58	77.9
Arkansas	9	74.3	11.4	23.4	23.9	—	—	1.14	54.2
Kentucky	10	73.6	13.4	27.2	20.9	5.5	—	1.27	64.4
Louisiana	11	70.7	6.7	17.8	18.3	—	9.7	.56	65.5
Alaska	12	68.4	26.2	—	23.3	—	6.5	1.61	86.8
Oklahoma	13	66.7	10.0	11.6	27.0	—	4.2	1.35	46.0
Median Average		(74.7)	(12.8)	(23.6)[2]	(20.9)	N.C.	N.C.	(1.14)	(68.4)
				State Strong Fiscal Partner					
Georgia	14	65.3	13.1	23.2	30.8	—	—	1.44	61.4
Idaho	15	64.8	16.3	16.7	34.8	—	—	1.72	44.6
Washington	16	64.3	—	25.9[1]	36.5	*	1.0	1.62	54.7
Utah	17	64.0	15.4	24.5	34.9	—	2.6	1.49	57.3
Florida	18	62.5	—	27.5	32.5	—	—	1.41	61.7
Tennessee	19	62.2	1.0	24.9	26.7	—	6.8	1.53	52.1
Pennsylvania	20	61.5	11.6	15.6	27.6	8.3	—	2.16	46.2
Vermont	21	61.1	17.8	8.3	38.3	—	—	2.53	35.2
Rhode Island	22	60.4	13.3	18.3	39.1	—	—	2.21	37.1
Arizona	23	60.2	9.6	22.7	38.6	—	5.4	1.65	47.5
Wisconsin	24	59.8	21.9	14.1	42.9	—	—	3.01	31.7
Virginia	25	59.6	18.3	13.0	28.2	*	4.3	1.32	37.7
Michigan	26	59.2	14.0	19.1	39.1	2.8	—	2.02	43.0
Minnesota	27	58.8	21.5	12.0	40.1	—	0.1	2.05	48.1
North Dakota	28	58.1	7.2	22.5	41.1	—	—	2.08	31.3
Texas	29	57.4	—	18.5	38.3	—	3.3	1.91	52.7
Maryland	30	57.2	20.6	13.1	31.9	9.3	—	2.24	37.4
Maine	31	57.1	5.8	21.2	43.3	—	—	2.43	34.7
Nevada	32	56.5	—	18.8	34.7	—	1.8	1.48	40.2
Wyoming	33	55.2	—	21.4	49.3	—	0.1	1.38	36.6

(cont.)

Table II-3 cont.

State-Local Fiscal Systems, Significant Features: 1970-71 and 1971-72

State	All State Taxes, 1971-72 Rank	All State Taxes, 1971-72 %	Percentage of State-local taxes from — State Individual Income Tax, 1971-72	State General Sales Tax, 1971-72	State-Local Property Taxes, 1971-72	Local Income Taxes, 1970-71	Local General Sales Taxes, 1970-71	Average Effective Property Tax Rates, Existing Single Family Homes With FHA Insured Mortgages, 1971	State as % of State-Local Revenue (From Own Sources) for Local Schools, 1970-71
State Dominant Fiscal Partner									
Iowa	34	53.1	14.2	15.3	46.2	—	—	2.63	28.9
Illinois	35	52.5	13.0	17.1	41.1	*	3.5	2.15	36.6
Missouri	36	51.9	12.6	18.2	37.2	3.1	0.8	1.79	33.8
Colorado	37	50.9	14.8	15.9	40.7	*	5.6	2.45	31.9
Connecticut	38	50.8	3.1	18.4	48.8	—	—	2.38	23.9
Kansas	39	50.7	9.2	17.3	48.7	—	—	2.17	32.1
Indiana	40	50.5	12.1	18.6	49.5	—	—	1.96	33.2
Oregon	41	50.2	24.8	—	48.0	—	—	2.33	20.8
Median Average		(58.5)	(14.0)[3]	(18.4)[2]	(38.9)	N.C.	N.C.	(2.04)	(37.3)
State Junior Fiscal Partner									
Montana	42	49.7	18.5	—	50.4	—	—	2.19	26.1
Massachusetts	43	48.8	20.1	5.4	50.7	—	—	3.13	26.4
New York	44	48.4	17.4	10.6	36.7	3.6	6.9	2.72	50.1
Ohio	45	48.4	2.5[4]	16.5	43.0	7.4	0.4	1.47	29.8
California	46	47.9	13.1	14.3	47.6	0.1	3.9	2.48	37.1
Nebraska	47	46.2	7.8	14.5	50.3	—	1.0	3.15	20.1
South Dakota	48	42.5	—	19.4	53.8	—	0.7	2.71	16.0
New Hampshire	49	42.2	2.0	—	58.0	—	—	3.14	10.4
New Jersey	50	39.8	0.6	14.2	56.0	—	—	3.01	27.5
Median Average		(47.9)	(17.4)[5]	(14.3)[2]	(50.4)	N.C.	N.C.	(2.72)	(26.4)
Exhibit:									
District of Columbia	—	—	—		30.9	25.4	17.9	1.80	—
U.S. (excluding D.C.)		55.3	12.0	16.3	38.8	1.7	2.4	1.98	43.3
U.S. (including D.C.)		55.0	12.0	16.3	38.7	1.8	2.5	1.98	43.1

*Less than 0.05 percent. N.C.—Not computed.

1 Excluding business gross receipts.

2 For states with a general sales tax.

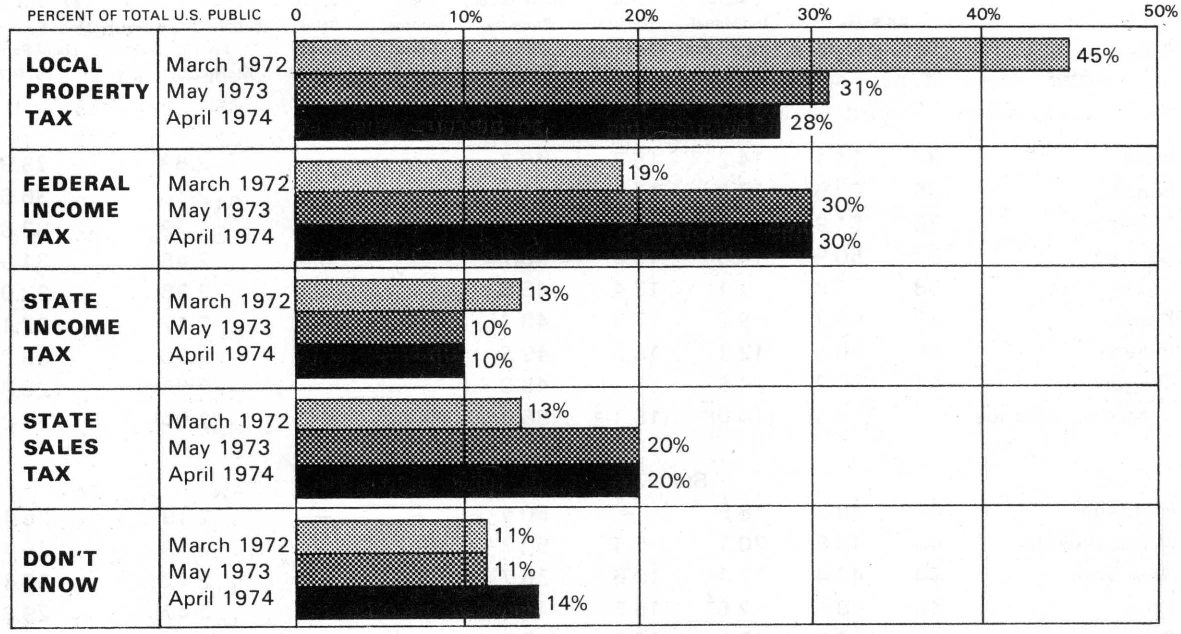
3 For the 21 states with a broad based individual income tax [excludes Connecticut and Tennessee].

4 Based on collections for partial year. New tax effective 1/1/72.

5 Based on the five states with a broad based tax for the entire fiscal year [excludes New Hampshire, New Jersey, and Ohio].

Source: ACIR staff calculations based on U.S. Bureau of the Census, Governments Division; U.S. Department of Housing and Urban Development, Federal Housing Administration; and National Education Association, Research Division; published and unpublished data.

FIGURE II-1
Public Opinion and Taxes
Which do you think is the worst tax — that is, the least fair?



Source: Advisory Commission on Intergovernmental Relations, Changing Public Attitudes on Governments and Taxes, Washington, D.C., June 1974

York — provides as much as 50 percent of school costs while seven provide one-third or less. As expected, the average effective property tax is correspondingly higher — a median rate of 2.72 percent, *one-third* higher than in the strong partner states and more than *two and one-third times* the median rate for the dominant state system. Five of the nine junior partner states authorize local sales or income taxes and eight provide at least some general support assistance for local governments.

Reasons Supporting the Revenue Diversification Objective

Unpopularity of the Property Tax

Although the local property tax plays a less prominent role in local government revenue structures than was previously the case, this decline in relative importance took place during a period when property tax rates and assessment ratios continued to climb. These increases in property tax burdens are particularly ominous as they occur in the face of systematic findings in surveys of public opinion on tax matters that the property tax is one of the tax sources least preferred by the taxpaying public.

ACIR Surveys

An appraisal of public attitudes towards taxes conducted for this Commission by the Opinion Research Corporation in March 1972 specifically asked: *Which do you think is the worst tax, that is, the least fair?*[1] The nationwide results showed that more than twice as many people singled out the local property tax than any other major tax source used by the three governmental levels:

	Percent of U.S. Public
1. Local Property Tax	45
2. Federal Income Tax	19
3. State Income Tax	13
4. State Sales Tax	13
5. Don't Know	10

Opposition to the local property tax was uniform among respondents of various socio-economic backgrounds. Regardless of age, income, area of residence, type of employment, race and other such factors, *each* subclassification decisively voted the property tax as being least fair — generally by margins of 2-to-1. Superimposed over this pervasive current of opposition, were pockets of even more intense hostility: among the elderly (60 years or over), farmers, and those residing in the north central and western regions. Those least opposed to the local property tax included residents in the southern and northeastern states, renters, and the young (those under 40). Even among these latter groups of respondents, however, the property tax was decisively chosen as the least fair of the major tax sources available to governmental levels.

To test the stability of public attitudes, the Commission asked the same question in May 1973 and April 1974. The results of these two surveys show that the property tax, while not necessarily the least favored tax, is still a major target of taxpayer discontent. Indeed, over the past three years, there has been a sharp decline in those singling out the property tax as the least fair — from 45 percent in 1972, to 31 percent in 1973, to 28 percent in 1974. (See Figure II-1.)

Harris Survey

A survey conducted by Louis Harris (February 16-19, 1973) further reveals taxpayer discontent with the local property tax.[2] When asked, *From your personal standpoint, which of these taxes do you feel are too high, which too low, and which about right?*, more people felt the property tax was too high than any other major tax source. Compared to a similar survey in 1969, the Harris poll reveals an increase in those who felt their property taxes were too high — from 62 percent to 68 percent. Evidence is also manifest of taxpayer discontent with major Federal and state tax sources — the Federal income tax, Federal excise taxes, state sales taxes and state income taxes — all of which were considered "too high" by more than half of the respondents. Yet, none of these tax instruments reached the 68 percent pinnacle of taxpayer discontent registered for the local property tax.

	Too High	Too Low	About Right	Not Sure
	(percent)			
Local Property Taxes				
1973	68	—	23	9
1969	62	1	22	15
Federal Income Tax				
1973	64	—	29	7
1969	66	1	24	9
Federal Excise Taxes				
1973	59	1	30	10
1969	56	1	28	15
State Sales Taxes				
1973	56	1	40	3
1969	60	1	32	7
State Income Taxes				
1973	53	1	34	12
1969	40	1	38	31
Federal Corporate Taxes				
1973	21	18	14	47
1969	16	10	10	64

Urban Observatory Survey

Citizens in ten large cities (Albuquerque, Atlanta, Baltimore, Boston, Denver, Kansas City [Kansas], Kansas City [Missouri], Milwaukee, Nashville and San Diego) were asked by the Urban Observatory, *If more tax money is needed, which do you think is the best way to raise it? Which is the next best way?*[3] The results of that survey showed the local sales tax to be a uniform first preference, the local income tax to be a general second choice and the local property tax near to or at the bottom of the list (which also included a tax on utilities and a tax on car owners). Citizens in Albuquerque, Denver, Kansas City (Kansas), and Milwaukee all ranked the property tax as the last choice; citizens in Kansas City (Missouri) and Nashville chose the local property tax as their next to last preference while in Atlanta, Baltimore, Boston and San Diego, the property tax placed third.

Of particular significance is the fact that in all ten cities surveyed, citizens preferred an increase in the local sales tax to an increase in the local property tax if additional tax money was needed.

Nearly equally uniform, but by less decisive margins, citizens in nine of the ten cities preferred an increase in the local income tax to an increase in the property tax.

means the exclusive province of the general public. Tax experts have long shared this concern. This Commission has previously studied the economic and administrative deficiencies of the property tax

	Tax On				
	Property	Income	Utilities	Sales	Car Owners
Albuquerque	9%	20%	13%	41%	9%
Atlanta	14	17	10	42	13
Baltimore	15	10	14	37	17
Boston	15	16	12	35	14
Denver	9	23	11	33	12
Kansas City (Kansas)	6	23	8	47	11
Kansas City (Missouri)	6	28	3	44	12
Milwaukee	8	22	10	28	22
Nashville	16	21	7	31	18
San Diego	13	15	11	44	10

Source: Urban Observatory, National League of Cities, *City Taxes and Services: Citizens Speak Out.*

These several public opinion surveys, then, amply substantiate the hostility to the property tax among the taxpaying public. This in itself is a valuable finding as it documents the degree of opposition local officials can anticipate should they decide to increase property tax rates. Yet, these studies do more than rest on a negative conclusion since they suggest alternative tax instruments that are more palatable to the taxpaying public. Summarizing these public attitudes and speculating on their implications for future State-local tax policies, Vito Tanzi has stated:

> There is little doubt, given the choice, the majority of the taxpayers would prefer indirect over direct taxes regardless of the opinion of the tax experts on the topic. In particular with respect to state and local governments of the United States, they would prefer sales taxes to income taxes and income taxes to property taxes. There is little doubt too that as the level of taxation rises, these preferences will manifest themselves in an always clearer fashion. Thus if one had to make a bet on the future development of the state and local tax structure one would be wise to put his money on an increasing role for indirect taxes.[4]

Reasons for Unpopularity

The indictment of the property tax is by no means the exclusive province of the general public. Tax experts have long shared this concern. This Commission has previously studied the economic and administrative deficiencies of the property tax and concluded that major reforms were warranted – reforms to be undertaken by the states and localities.[5]

The unpopularity of the property tax is undoubtedly attributable to a number of factors, some of which relate to aspects that are peculiar to the tax itself.

- No other major tax in our public finance system bears down so harshly on households in general or is so capriciously related to ability to pay.

- Compared to the preferential treatment accorded shelter outlays under the Federal income tax, the property tax stands out clearly as an antihousing levy. As the tax is increased, it becomes a more serious threat to homeownership.

- Unlike income, sales, and even death taxes, the property tax imposes a levy on unrealized capital gains. Undoubtedly, many property owners do not share the view that unrealized capital gains are an acceptable source of taxation. Homeowners, especially, are apt to view the increase in the value of their home as mere "paper profits," without a concomitant increase in their ability to pay.

- The property tax is a highly visible,

"lump sum" payment. Even for those property taxpayers who send in their payments with the monthly mortgage, there are 12 installments annually, less than half the 26 biweekly income tax deductions. Under withholding, the tax payment is also less visible, being automatically deducted while the property tax payment takes place only by explicit action. By far the sharpest contrast in terms of number and size of payments, however, arises with the sales tax — where tax liability is discharged on innumerable occasions in relatively small amounts.

According to the 1974 ACIR public opinion survey, the most important reasons for dissatisfaction with the property tax were that it imposed the hardest burdens on the low income families, in the view of 27 percent of the respondents, and that the tax was based on home values that were not always fair, selected by 21 percent.[6] Other reasons, though cited less frequently, included the discouraging effects of the property tax on homeownership (12 percent); the fact that the tax was levied on any increase in the value of a home over the original purchase price, even though that increase is only on paper and not in the homeowner's hands unless he sells the house (12 percent); and that property taxes have been going up faster than other taxes (12 percent).

Netzer summarizes the defects of the property tax as:

> The major defects which seem to be inherent in the property tax are these:
>
> 1) its adverse effects on the central city housing stock;
>
> 2) the difficulty in uniformly assessing business property;
>
> 3) the horizontal inequity of housing taxes within income classes;
>
> 4) the regressivity of housing taxes among tenants and among homeowners; and
>
> 5) the lack of neutrality among types of economic activity, particularly in connection with taxes on transportation and public utility property.[7]

Professor Netzer then concludes:

> To the extent that the defects of the property tax are inherent ones, the principal remedies must take the form of some reduction in the reliance on the property tax for the financing of urban public services. (This does not necessarily mean a rollback in property tax levies or rates. In practice it will mean a reduction in the *relative* role of the property tax; that is, financing increased expenditures in future years from revenue sources other than the property tax.) The alternative financing is by higher levels of government which do not use the property tax, or by other local government revenue sources.[8]

Growing Height of the Property Tax

Aside from public hostility to the property tax, there is the simple — but frequently overlooked — point that the property tax burden has risen sharply. For the nation as a whole, the average effective property tax rate (the percentage that tax liability is of market or true value of the house) on existing single family homes with FHA insured mortgages has increased from 1.34 percent in 1958, to 1.53 percent in 1962, to 1.70 percent in 1966 and to 1.98 percent in 1971. (See Table II-4.) Nationwide, this translates into more than a 3.5 percent annual increase on the average, for each year since 1958.

This nationwide increase in effective property tax rates is indeed national in scope. With but few exceptions, an increase in effective rates was registered for each state between the benchmark years, though the rate of increase naturally differs among the states. The pervasiveness of the increase, however, is readily demonstrated. Excluding the 12 southeastern states (Virginia, West Virginia, Kentucky, Tennessee, North Carolina, South Carolina, Georgia, Florida, Alabama, Mississippi, Louisiana and Arkansas) where effective rates in the selected years never hit the 2.00 percent level, the number of states where the effective rate hit or exceeded the 2.00 percent figure doubled between 1958 and 1962 (from four states to eight states) and doubled again between 1962 and 1966 (climbing to 16 states), while seven states were added to the list between 1966 and 1971, making the total 23.

Similar developments have taken place in the 50 largest SMSAs. The median effective rate for these areas has shown an uninterrupted ascent — 1.42 percent in 1958, 1.71 percent in 1962, 1.95

Table II-4

Average Effective Property Tax Rates, Existing Single Family Homes with FHA Insured Mortgages, by State and Region, Selected Years: 1958-1971[1]

State and Region	1971	1966	1962	1958
United States	1.98	1.70	1.53	1.34
New England				
Maine	2.43	2.17	1.81	1.58
New Hampshire	3.14	2.38	2.03	1.81
Vermont	2.53	2.27	2.10	1.63
Massachusetts	3.13	2.76	2.47	2.21
Rhode Island	2.21	1.96	1.93	1.67
Connecticut	2.38	2.01	1.75	1.44
Mideast				
New York	2.72	2.40	2.23	2.09
New Jersey	3.01	2.57	2.22	1.77
Pennsylvania	2.16	1.88	1.75	1.50
Delaware	1.26	1.14	.91	.71
Maryland	2.24	2.05	1.74	1.47
Dist. of Columbia	1.80	1.37	1.18	1.08
Great Lakes				
Michigan	2.02	1.81	1.76	1.45
Ohio	1.47	1.44	1.24	1.07
Indiana	1.96	1.64	.96	.84
Illinois	2.15	1.96	1.79	1.35
Wisconsin	3.01	1.21	2.24	1.82
Plains				
Minnesota	2.05	2.14	1.79	1.57
Iowa	2.63	2.12	1.66	1.34
Missouri	1.79	1.64	1.36	1.12
North Dakota	2.08	1.81	1.70	1.54
South Dakota	2.71	2.64	2.31	2.01
Nebraska	3.15	2.67	1.84	1.90
Kansas	2.17	1.96	1.92	1.65
Southeast				
Virginia	1.32	1.13	1.03	.90
West Virginia	.69	.71	.79	.56
Kentucky	1.27	1.03	.94	.93
Tennessee	1.53	1.37	1.18	.97
North Carolina	1.58	1.31	1.17	.90
South Carolina	.94	.60	.53	.48
Georgia	1.44	1.30	.94	.84
Florida	1.41	1.09	.66	.76
Alabama	.85	.66	.52	.56
Mississippi	.96	.93	.76	.66
Louisiana	.56	.43	.49	.52
Arkansas	1.14	1.09	1.09	.84
Southwest				
Oklahoma	1.35	1.11	.86	.86
Texas	1.91	1.62	1.44	1.36
New Mexico	1.70	1.30	.98	.93
Arizona	1.65	2.41	2.27	2.14
Rocky Mountain				
Montana	2.19	1.70	1.58	1.32
Idaho	1.72	1.23	1.13	1.14
Wyoming	1.38	1.34	1.27	1.17
Colorado	2.45	2.20	1.85	1.72
Utah	1.49	1.52	1.31	1.05
Far West				
Washington	1.62	1.14	1.12	.92
Oregon	2.33	1.98	1.83	1.55
Nevada	1.48	1.47	1.31	1.06
California	2.48	2.03	1.71	1.50
Alaska	1.61	1.42	1.24	1.12
Hawaii	.92	.81	.77	.62

[1] Effective tax rate is the percentage that tax liability is of the market or true value of the house.

Source: Computed by ACIR staff from data contained in U.S. Department of Housing and Urban Development, Federal Housing Administration, Statistics Section, Data for States and Selected Areas on Characteristics of FHA Operations Under Section 203; 1971 data from unpublished FHA tabulations.

Table II-5

Average Effective Property Rates, Existing Single Family Homes with FHA Insured Mortgages, 50 largest SMSAs, by Region Selected Years: 1958-1971[1]

Standard Metropolitan Statistical Area and Region	1971	1966	1962	1958
Median of 50 SMSAs	2.13	1.95	1.71	1.42
New England				
Boston	3.21	2.70	2.46	2.24
Hartford	2.88	2.22	1.96	1.55
Providence	2.34	2.04	2.01	1.72
Mideast				
Albany	2.45	2.44	2.55	2.13
Baltimore	2.25	2.37	1.96	1.59
Buffalo	2.24	2.70	2.31	1.82
New York	2.68	2.49	2.26	2.10*
Newark	2.93	2.63	2.21	**
Paterson	2.53	2.30	2.02	**
Philadelphia	3.08	2.47	2.20	1.70
Pittsburgh	2.46	1.83	1.57	1.42
Rochester	2.72	2.13	1.95	1.66
Washington	1.93	1.63	1.34	1.24
Great Lakes				
Akron	1.62	1.58	1.32	1.20
Chicago	2.16	2.02	1.95	1.39
Cincinnati	1.52	1.60	1.35	1.11
Cleveland	1.88	1.62	1.39	1.23
Columbus	1.53	1.33	1.11	0.86
Dayton	1.38	1.51	1.32	1.09
Detroit	2.03	1.86	1.87	1.56
Indianapolis	2.29	2.10	1.06	0.84
Milwaukee	3.52	2.71	2.62	1.93
Toledo	1.30	1.37	1.19	0.95
Plains				
Kansas City	1.76	1.58	1.35	1.16
Minneapolis	2.08	2.16	1.82	1.67

Standard Metropolitan Statistical Area and Region	1971	1966	1962	1958
Plains - continued				
St. Louis	2.09	1.82	1.51	1.14
Southeast				
Atlanta	1.52	1.50	1.04	0.97
Birmingham	0.98	0.84	0.68	0.66
Louisville	1.29	1.09	1.03	1.01
Memphis	1.98	1.80	1.61	1.05
Miami	1.40	1.25	0.62	0.73
New Orleans	0.48	0.38	0.55	0.53
Norfolk	1.13	0.95	0.99	0.96
Tampa	1.50	1.04	0.82	0.98
Southwest				
Dallas	1.83	1.43	1.26	1.27
Ft. Worth	2.21	1.97	1.73	1.70
Houston	1.85	1.67	1.36	1.24
Oklahoma City	1.31	1.11	0.82	0.85
Phoenix	1.62	2.58	2.36	2.18
San Antonio	2.21	1.84	1.86	1.65
Rocky Mountain				
Denver	2.45	2.17	1.86	1.69
Far West				
Anaheim	2.19	1.94	NA	NA
Los Angeles	2.85	2.17	1.71	1.44
Portland, Oregon	2.28	2.01	1.77	1.58
Sacramento	2.44	2.19	1.84	1.65
San Bernardino	2.34	2.00	1.75	1.58
San Francisco	2.76	1.96	1.64	1.53
San Jose	2.61	2.12	1.85	1.62
Seattle	1.82	1.17	1.14	0.91

NA - Data not available

*New York - Northeastern New Jersey

**Included in New York - Northeastern New Jersey

[1] Effective tax rate is the percentage that tax liability is of market or true value of the house.

Source: Computed by ACIR staff from U.S. Department of Housing and Urban Development, Federal Housing Administration, Statistics Section, Data for States and Selected Areas on Characteristics of FHA Operations Under Section 203; 1971 data from unpublished FHA tabulations.

percent in 1966, 2.13 percent in 1971. (See Table II-5.) On the average, the rate of increase has been just under 4 percent, for each year since 1958. Twenty-seven of the 50 largest SMSAs had effective property tax rates in excess of 2.00 percent in 1971 compared to 21 in 1966, ten in 1962 and but four in 1958.

These high and rising property tax rates have served to sharpen the focus on the inequities of the tax instrument. Equally significant, they undoubtedly have acted as a brake on the ability of local policymakers to further increase property taxes for, as is true with any tax source, the higher the rate the more difficult it becomes to make more intensive use of the tax. This is not to say, however, that the case for greater revenue diversification rests on a property tax exhaustion thesis. It cannot be claimed with any degree of assurance that local governments, either everywhere or in general, have gone as far as taxpayer toleration will permit. What does seem clear, however, is that alternatives to the property tax appear particularly attractive in the face of the demonstrated unpopularity of the property tax and the steady increases registered by this levy.

Local Lid Laws

The state sector has promoted revenue diversification — albeit in an indirect way — by its renewed interest in placing lids or limitations on the property tax or, in some cases, on local government expenditures. Such programs, designed to respond to demands to control local government spending, are sometimes accompanied by a *quid pro quo* — increased state funding for public schools or authorization of local non-property taxes.

Kansas. The 1973 legislature made permanent a property tax lid law first enacted in 1970. The restrictions on rates and operating budgets apply to cities, counties and junior college districts. Exceptions were provided for, and voters can approve increases in, one or both lids. The 1973 legislation permits any county to impose a 0.5 percent sales tax, subject to voter approval, provided the tax has the same base as the state and is collected by the state. Half the revenues are returned to counties, cities, and junior college districts in proportion to property taxes levied, the other half is returned to each county and city in relation to non-urban population of the county and total population of the city. Special provisions are in effect for the three cities (Lawrence, Manhattan and Topeka) that adopted the sales tax under the 1970 legislation. The local earnings tax, also authorized in 1970, was terminated by the 1972 legislature.

Indiana. To reduce local reliance on the property tax, counties are authorized to adopt income taxes, with flexibility in the choice of rate. Depending on the particular rate adopted, a specified portion of the income tax yield must be used to provide property tax relief. Under the legislation, property tax rates are frozen in non-adopting counties; property tax levies are frozen for school corporations and in adopting counties. Approximately one-third of the counties adopted the income tax, but none of the major urban counties in the state has chosen the local income tax option. In part, this may reflect the fact that the city-county conflict is stronger in the urban areas and thus there is greater reluctance to adopt county income taxes and share revenues with city officials. (City officials do not have the option of adopting the income tax in the event that the county does not levy the tax.) It is also, of course, possible that the lack of local income tax adoptions in urban areas results from less discontent with the property tax than is true in rural sectors.

Maine. The Maine program couples increased state funding for public education with property tax restrictions. As the legislation states, "It is declared to be the intent of the legislature to reduce the burden of education program costs in public schools which are borne by the property tax to 40 percent and to provide 60 percent of the total cost of education from state tax sources. The legislature intends that a limit be placed upon additional local taxes that may be imposed on property for school purposes, thus encouraging more efficient management of the available resources."

Wisconsin. Local governments — towns, villages, cities and counties — are restricted to a 1974 operating budget that may not increase more than the levy for the 1973 operating budget multiplied by the statewide growth in property valuation, subject to a 6 percent minimum guaranteed increase. The limit may be exceeded if (a) local population growth exceeded that of the state, (b) the municipality assumes a responsibility previously administered by another governmental unit or (c) the electors determine by referendum that this limit shall not apply. Citizens may begin class action to enjoin collection of property taxes if the levy exceeds that permitted. School districts are restricted to a $55 per pupil increase in school costs for the 1973-74 school year, exclusive of costs related to transportation, debt service, annual capital outlay and that portion of the employers share of retirement and social security payments which exceeds $7.50 per pupil.

In addition to this lid law, the 1973 legislature acted to take over certain functions previously performed by counties, increased state payments for school aids, and raised the direct credits on property tax bills. As a result of this multifaceted program, property tax rates decreased by nearly 11 percent while the gross tax levy also declined — the latter being the first such decrease during the post World War II era. (See Table II-6.)

California. In November, the California electorate defeated Article 29, which included a provision to establish a tax rate limitation for cities, counties and special districts. The limit was defined as the tax rate in effect for 1971-72 or 1972-73, whichever is higher. School districts were not included in this limit as statutory law presently includes limitations for school districts. Tax rates beyond the limit were permitted for "special cir-

Table II-6

Wisconsin Property Tax Trends

Levies, Full Values, Rates, Relief: 1964-1973
(Amounts in Millions of Dollars)

Year of Levy	Gross Tax Levy Amount	Gross Tax Levy Percent Change	Full Value Amount	Full Value Percent Change	Tax Rate[1] Rate	Tax Rate[1] Percent Change	Property Tax Relief General Property[2]	Property Tax Relief Specified Personal[3]	Property Tax Relief Total
1964	$ 620.4	6.5%	$22,291	4.6%	$27.84	1.9%	$ 45.7	$ 33.1	$ 78.8
1965	664.1	7.0	23,456	5.2	28.32	1.7	48.6	39.3	87.9
1966	721.3	8.6	25,227	7.6	28.59	1.0	48.5	49.0	97.5
1967	830.5	15.1	27,104	7.4	30.65	7.2	51.6	57.7	109.3
1968	957.6	15.3	28,906	6.6	33.13	8.1	51.7	65.4	117.1
1969	1,055.6	10.2	31,433	8.7	33.58	1.4	59.6	70.5	130.1
1970	1,179.0	11.7	34,790	10.7	33.89	0.9	59.5	80.1	139.6
1971	1,301.0	10.3	37,263	7.1	34.92	3.0	88.5	85.7	174.2
1972	1,326.7	2.0	40,833	9.6	32.49	-7.0	140.4	92.1	232.5
1973	1,323.0[4]	-0.3	45,513	11.5	29.07	-10.5	184.2	116.7	300.9
Ten Year Percent Increase		113.3%		104.2%		4.4%	303.1%	252.6%	281.9%

[1]Per $1,000 of full value.

[2]Excludes property tax relief for utilities.

[3]Merchants' stocks, manufacturers' materials and finished products and farm livestock.

[4]Estimated amount.

Source: *The Wisconsin Taxpayer,* June 1974, Vol. 42, No. 6, p. 3.

cumstances creating hardships" to pay the cost of an "emergency situation," or by vote of four-fifths of the governing board. Exempted from the maximum rates were (1) expenditures to pay indebtedness, (2) expenditures to pay for retirement and pension benefits and (3) expenditures required by the obligation to levy taxes under the Improvement Bond Act of 1915. The maximum rates could have been adjusted by a vote of the electorate to reflect transfers of functions among governmental levels, and if the growth in population and prices combined exceeded the growth in assessed value.

Local government units, including school districts, were also authorized to impose corporate and personal income taxes, subject to a two-thirds vote of the legislature. This provision, however, merely raised the legislative vote necessary from a majority to a two-thirds vote since the constitution did not prevent the legislature from authorizing local income taxes.

Minnesota. All counties, cities, villages, boroughs, and towns having the powers of villages in excess of 500 population are restricted to an increase not to exceed 6 percent of the previous year's limit. The limit may be pierced, however, by a majority vote of the local electorate. Some significant rollbacks in property tax rates subsequently took place — particularly in school districts where increased state funding of education was the main cause. While there has been some legislative and administrative erosion of the lid law, the fact remains that the rate of increase in property taxes has been dramatically reduced.

Analysis of State Revenue Diversification Policies

To achieve greater revenue diversification and a more balanced use of income, sales and property taxes, states will have to continue — and indeed increase — one or more of three policies. Revenue diversification can be achieved either by state assumption of functions or programs previously financed by local governments, by increasing intergovernmental grants-in-aid to localities or by authorizing local governments to adopt local sales and income taxes. These three policies share one salient characteristic — they increase reliance on either state or local utilization of sales and income taxes and decrease the need for heavier dependence on the property tax. The three state approaches do, however, differ significantly in terms of (1) political accountability, (2) centralization-decentralization policy mix between state and local governments, (3) equalization or disparities potential and (4) administrative and compliance costs for the taxpayer.

Before proceeding, however, it is essential to stress that the following analysis assumes a coordinated state-local approach to local income or sales taxes — a high degree of uniformity among local tax instruments. An essential state safeguard calls for the tax base to be adopted by local governments to be identical among themselves and, unless the state tax base is seriously deficient, that the local base also be the same as that of the state.

Additional safeguards that are highly desirable — but not quite as essential as the uniform tax base requirement — include state collection and administration of the local tax, so as to prevent duplicative tax administration costs; the requirement that the local non-property tax be imposed by a large number of jurisdictions encompassing a large portion of the state population, so as to minimize interlocal tax competition; a provision that the rate of tax imposed by local officials be confined within a range of rates specified by the state, both to permit local initiative and to reduce interlocal tax differentials and their consequent influence on individual and business shopping and location decisions; determination of sales tax liability by location of vendor, rather than customer, and the prohibition of local use taxes on intrastate purchases.

Equipped with these safeguards, the pitfalls of a non-systematic, uncoordinated utilization of local non-property taxes will be largely avoided. Indeed, these conditions turn local non-property taxes close to a statewide tax, shared among local governments on an origin basis.

Political Accountability

Undoubtedly one of the driving forces behind the spread of local income and sales taxes is the unwillingness of state policymakers to accept the onus associated with heavier income and sales taxes at the state level. This reluctance of state policymakers to accept the blame for higher taxes is especially evident when they are considering an alternative revenue diversification measure — unconditional state revenue sharing. State opposition to unconditional revenue sharing harkens back to a basic premise that underpins traditional views on fiscal federalism — that the pain of taxation should not be divorced from the pleasure of public expenditure. State policymakers can also argue that all communities do not need a higher level of public expenditure. By way of contrast, an optional local income or sales tax approach permits political responsibility to be focused where the additional revenues are needed and thereby establishes the nexus of expenditure pleasure-taxation pain at the local level.

Centralization-Decentralization Issue

Perhaps the most obvious distinction among the three state policies is the degree to which they influence the centralization-decentralization policy mix. Quite obviously, direct state provision of a public service will result in more centralized government at the state level than would authorization of local non-property taxes, where initiative will remain with locally elected officials. Intermediate in this spectrum is the intergovernmental grant device and here it is critical to distinguish between categorical and unconditional aids. The categorical aid device is, by definition, restricted to specific purposes; depending upon the number of conditions attached to it, the categorical aid can be a highly centralizing fiscal tool, though less so than state assumption of complete financial and administrative responsibility for a function. Indicative of this tendency, though not in terms of state-local fiscal relations is the following:

> The root cause of the loss of local autonomy, however, is the loss of local fiscal independence. Restricted in their taxation powers, but faced with an increasing demand for locally provided services and the rising costs of providing these services, local governments in most countries have been forced to turn, directly and indirectly, to their national governments for greater financial assistance. In many instances national governments have responded and made funds available. Thus national governments have been able to increase their influence on state/provincial and local government expenditures and to utilize these opportunities to implement policies geared to the achievement of national economic goals.[9]

By way of striking contrast, unconditional grants-in-aid represent a far more decentralizing device since local policymakers retain wide latitude in the use they make of the funds. Yet, the unconditional grant is not as decentralizing in its effects as are local non-property taxes. The local official in the former case is a recipient of a share — determined by formula and applied to a fiscal sum, but the size of the fiscal pot and the distribution formula are not directly determined by the local official.

Equalization Versus Disparities

Particularly since the *Serrano* decision in educational finance, the spotlight has been placed on the issue of disparities in the provision of public services. So long as fiscal resources are distributed unequally, reliance on local initiative and willingness to support public sector activities will continue to produce differences in the level of services made available by localities — reflecting not only differences in capacity and willingness but local needs and tastes for public services.

Reliance on local initiative, then, is bound to produce differences, diversities, and disparities. Equalization of these disparities, in turn, becomes a function to be performed by upper governmental levels.

Each of the three state policies discussed here — state assumption, unconditional local government support grants and authorization of local non-property taxes — can be designed, in theory, to produce a greater degree of equalization in the state-local fiscal system. Yet, practically speaking, equalization of local general government fiscal resources stands out as the exception rather than the rule in actual state government practice.

The state assumption approach, conceptually, appears to offer the most clear cut path to reducing local disparities. The higher the level of state financing, the lesser the reliance on local resources and hence the lesser opportunity for introducing local variations. Moreover, once a given core of public services, or of a particular service, is provided, concern over disparities becomes of lesser importance. Nonetheless, this lessened disparities potential is not without its attendant costs. If a state decides to take over a previously locally financed function, it will have to deal with the "levelling up" problem — setting the level of service the state will underwrite. Unless this state set level is at the highest existing rate, recipients of the program will suffer a cutback in services received. Thus, there is usually great political pressure to set the state rate at a high level with the inevitable increase in program cost.

In theory, then, state assumption could produce statewide uniformity in service levels — at considerable expense to the state sector. In actual practice, it seems more likely that state takeover will yield some combination of an expensive state program with local add-ons confined to a limited range.

In theory, state grants — whether conditional or unconditional in nature — offer a second vehicle toward the equalization objective. Aside from the education function, however, conditional state government grants rarely are provided on an equalizing basis.[10] Indeed, the very same can be said for existing state programs of unconditional support to local governments. Most of these programs return state collected funds on the basis of origin and as such perform an antiequalization role. While Wisconsin and New York stand out by providing substantial amounts of general local government support on an equalizing basis, the general rule remains that in most states unconditional grant programs are too anemic to make much impact on reducing local disparities and the few that do attempt to are, at best, mildly redistributive in their effect.

Authorization of local non-property taxes, because of its reliance on unevenly distributed local sales and income tax capacities, will contribute to additional fiscal disparities. Indeed, the distribution of local non-property taxes can be particularly uneven in fragmented metropolitan areas. Yet, the disparities producing potential of local non-property taxes can be lessened — by positive state action. Empirical evidence exists that strongly suggests the disparities producing potential of local non-property taxes is far less among large jurisdictions — such as counties — than among small areas. The state sector then, without committing additional fiscal resources of its own, can contain local non-property tax disparities by restricting the authorization of their use to counties and to the larger cities; say those in excess of 25,000 population.

Further, states can, and some, though not many do, require redistribution among local jurisdictions *within* the county. That is, countywide receipts from a particular local non-property tax are divided up among jurisdictions on some basis other than origin of receipts. This produces some redistribution among the local jurisdictions within a county but does nothing to equalize among the counties (where the disparities are presumably less to begin with). As with the restriction of non-property taxes to larger units of local government, the redistribution of revenues within these jurisdictions requires no additional state financing.

Tax Administration and Taxpayer Compliance

Both state takeover and increased grants-in-aid, because they are financed from state tax sources, have a slight advantage over the system of coordinated local non-property taxes in terms of taxpayer convenience. Yet, the terms of the coordinated system of local non-property taxes contemplated here are deliberately designed to minimize the potential compliance difficulties associated with local sales and income taxes. To the extent that these local taxes are state administered and adhere to the state definition of the tax base, the major difficulties associated with local sales and income taxes should be surmounted. Local rate variations could cause some difficulties but these would seemingly be minimal if tax situs is defined as the point of sale, for the sales tax, and sharing arrangements are specified for areas of employment and residence, under the income tax.

In sum, local sales and income taxes present potentially some additional difficulties both to taxpayers and business firms. If coordinated and systematized with state taxes, however, these taxes should be readily workable instruments with minimal additional inconvenience. As a result, this issue would be far less significant than the centralization, disparities, and political accountability considerations when evaluating the various means to achieve a more diversified and balanced state-local utilization of income, sales and property taxes.

FOOTNOTES

[1]Advisory Commission on Intergovernmental Relations, *Public Opinion and Taxes,* Washington, D.C., May 1972, p. 2.

[2]*Washington Post,* April 14, 1973, p. A13.

[3]Urban Observatory, National League of Cities, *City Taxes and Services: Citizens Speak Out,* p. 10.

[4]Vito Tanzi, "Taxpayers Choices in Future Tax

Shifts," *Tax Review*, Vol. XXXIII, No. 11, November 1972, p. 44.

[5]Advisory Commission on Intergovernmental Relations, *Financing Schools and Property Tax Relief, A State Responsibility*, p. 30.

[6]Advisory Commission on Intergovernmental Relations, *Changing Public Attitudes on Governments and Taxes*, S-3, June 1974.

[7]Dick Netzer, *Impact of the Property Tax: Its Economic Implications for Urban Problems*, National Commission on Urban Problems, Joint Economic Committee, 90th Congress, 2nd Session, Washington, D.C., 1968, p. 35.

[8]*Ibid*, p. 36.

[9]International Association for Metropolitan Research and Development, *A Study of the Financial Practices of Governments in Metropolitan Areas*, Toronto, Canada, May 1973, p. 4.

[10]Advisory Commission on Intergovernmental Relations, *State Aid to Local Governments*, Washington, D.C., 1969, passim.

Chapter III

Local Sales Taxes: Intergovernmental Issues

The first local sales tax was adopted by New York City in 1934, closely followed by a New Orleans levy, initially adopted in 1936, and made into a general tax in 1938. The local sales tax "movement" however, is distinctly a product of the postwar period. Authorization of local sales taxes by California and Illinois in the late 40s and early 50s fueled this movement, a movement that reached its most rapid rate of advance in the years 1963-1970. During these seven years, 13 states authorized local sales taxes for at least some of their jurisdictions, thereby doubling the number of states that gave their local governmental units access to this tax instrument. As of January 1, 1973, 26 states permitted one or more of their local governmental jurisdictions to levy a local sales tax.

Three reasons help explain the increased utilization of local sales taxes. Continued pressures for additional local revenues and increasing disaffection with the property tax have been twin spurs to the further spread of non-property revenues — sales, income and user charges. In part, the local sales tax movement may be the result of the much greater degree of public acceptance accorded by the taxpaying public for this tax instrument.

The Urban Observatory study showed that citizens in each of the ten cities surveyed preferred the sales tax by wide margins to increasing the property tax, the income or earnings tax, the utilities tax (electricity, gas or water) or the tax on automobile owners. Because there were five alternatives, the local sales tax option did not receive a majority vote as first choice; nonetheless, the sales tax was the uniform first choice in all ten cities and did receive a majority vote in each city studied as one of the two best ways to raise additional local revenues. The favorable response to the sales tax, if local taxes had to be raised, was pervasive among groups of various socio-economic factors and the study concluded, "For most cities and almost all groups, the sales tax was by far the most favored way of raising increased revenue from various tax sources . . . "[1]

The two public opinion surveys conducted for the Commission by the Opinion Research Corporation of Princeton, New Jersey, further support the greater acceptance of the sales tax by the taxpaying public. Although the choice was between a state sales tax and local property tax, as well as other Federal and state taxes, both ACIR surveys revealed a far greater degree of acceptance for the sales tax than the property tax. Nationwide, only 13 percent of the respondents felt the state sales tax was "least fair" in 1972 and each and every socio-economic classification revealed — generally by margins of 3-to-1 — less taxpayer discontent with the sales than the property tax.

The 1973 survey showed generally similar results, though the margin of difference was less decisive than in 1972. Twenty percent of the nationwide respondents felt that state sales taxes were least fair in 1973, twice the number selecting the state income tax but significantly less than the number singling out the Federal income tax (30 percent) and the local property tax (31 percent). There is no readily apparent reason for this 7 percent increase in discontent with state sales taxes. State tax actions in 1973 on the sales tax front, for example, are far too meager to give rise to this augmented public discontent. Regardless of the reasons, however, the sales tax — at least as utilized by the state sector — remains far more fair in the eyes of the taxpaying public than does the local property tax. Indeed, the preference for sales over property taxation, was shared by all socio-economic classifications in 1973, except non-whites (who disliked the Federal income tax, state sales tax and local property tax equivalently) and renters (whose greater distaste for the sales tax, 24 percent, is not significantly different from that accorded the property tax — 23 percent.)

It should be emphasized that while the question posed in the ACIR surveys related to state sales taxes and local property taxes, these taxpayer attitudes would seemingly be transferable to a system of coordinated local sales taxes. This is particularly the case in view of the fact that the type of local sales tax under consideration, like those in actual practice, would require a substantial degree of conformity with the state sales tax base. Moreover, because local sales tax rates would undoubtedly be lower than the state rate, as is the case in all states where both governmental levels presently utilize the tax, public preferences as revealed in the ACIR surveys may even understate the acceptability of a local sales tax as an alternative to further increases in local property taxation.

Local Sales Taxes: Extent of Use

In order for local governments to impose a sales tax, they must have either specific or implicit authority from the state constitution or state statute. This can take the form of home rule charter powers, general licensing powers or specific state legislation. By far the most frequent source of authority is the specific state statute, the exclusive source of authority for local sales taxes in 23 states.

Among the local sales tax States, Arizona and Alabama are the only two that provide no specific authority for cities; cities in these two states derive their sales tax authority from the business and occupational license powers. Alabama counties, however, are permitted to levy sales taxes by specific authority. In Colorado, a 1967 law authorized counties and all incorporated cities and towns to levy sales taxes, to be administered by the state. This statutory authority is in addition to the home rule cities which can levy sales and use taxes that are administered by the cities themselves.

More than 4,300 local jurisdictions of all types presently employ a local sales tax. The vast majority, 3,780, are municipalities; 614 counties, 47 school districts (all in Louisiana), 13 parishes (again, all in Louisiana), five boroughs (all in Alaska) as well as rapid transit districts in the San Francisco Bay Area and in Georgia also levy local sales taxes.

Despite the increase in the number of states authorizing local sales taxes and the number of local governments actually using them, the local sales tax is heavily concentrated in five States. The largest number of such taxes occurs in Illinois, where 1,245 municipalities and 100 counties impose the tax. The local sales tax is widely used in Texas (among 757 municipalities), California (380 municipalities, 58 counties, and one rapid transit district), Oklahoma (300 municipalities), and Alabama (206 municipalities and 25 counties).

Revenue Significance

In 1972, local sales taxes raised approximately \$3.7-billion and while running a distinct second to the property tax, sales taxes are nonetheless the second most lucrative individual source of tax revenue to local governments.

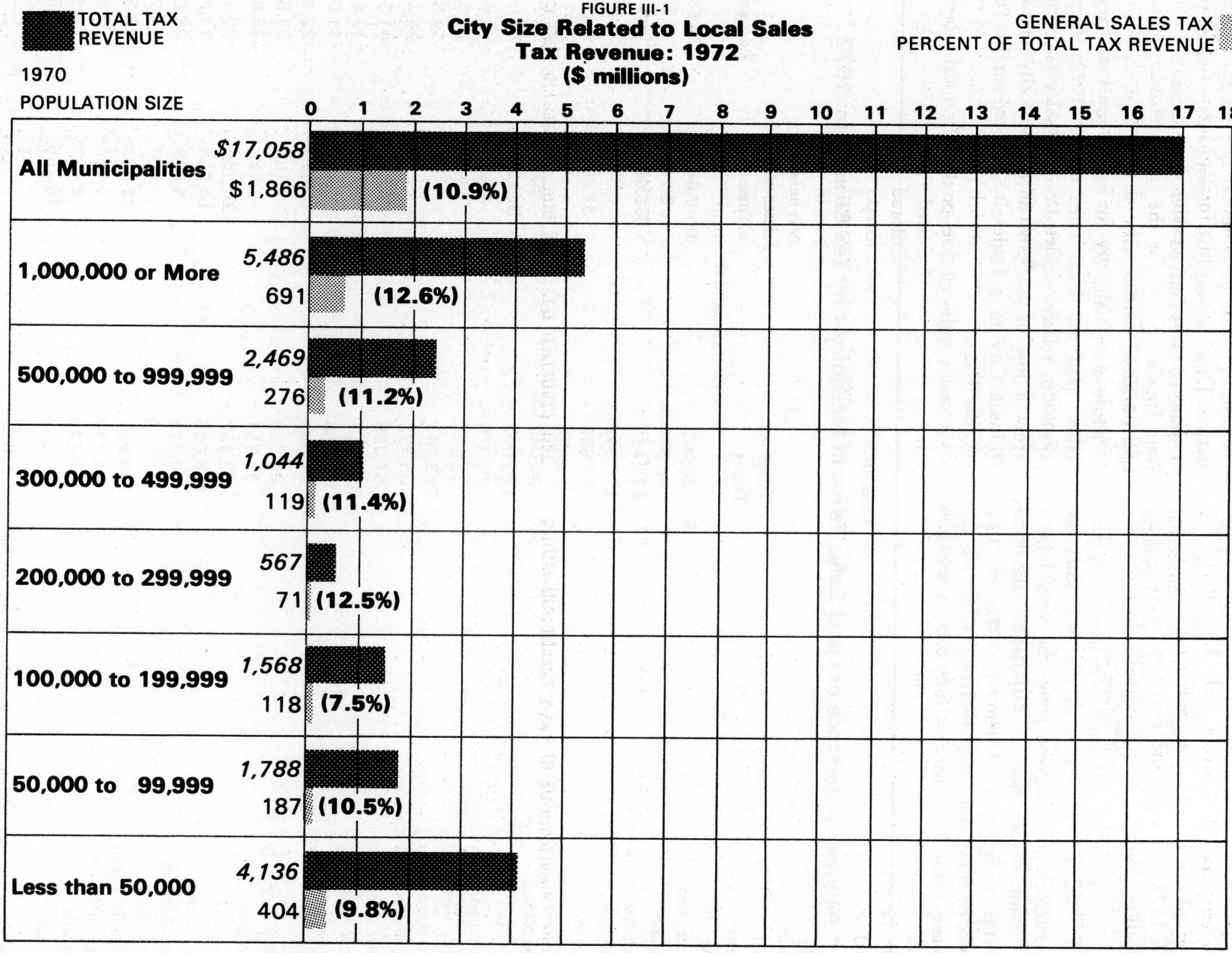
Relationship To City Size

The revenue significance of local sales taxes is more than somewhat obscured by aggregate data.

FIGURE III-1

City Size Related to Local Sales Tax Revenue: 1972

($ millions)



SOURCE: ACIR staff compilation based on **City Government Finances**, 1971-72.

Obviously, while many local governmental jurisdictions are now using this tax source, many more are not. Concentrating on municipal governments, the most frequent users of the tax, some $1.9-billion was raised by the general sales tax, an amount equal to 10.9 percent of total municipal tax revenue and 7.9 percent of municipal general revenue raised from own sources.

There is no clear relationship between city size and the relative importance of the local sales tax in municipal tax structures. For the very largest cities, 1-million or more in population, the local sales tax raised $691-million in 1972, or 12.6 percent of total taxes (Figure III-1). Cities of the next two size classifications (500,000 to 999,999 and 300,000 to 499,999) relied roughly equally on the local sales tax, 11.2 percent and 11.4 percent of tax revenues respectively. The next four size classifications of cities reveal no smooth progression — either upwards or downwards — in the percentage of taxes derived from sales levies.

48 Largest Cities

More than half, 26, of the nation's 48 largest cities used the local sales tax in 1972. Among these 26, relative reliance on the sales tax ranged from a low of 5.6 percent of total city taxes in Kansas City to a high of 55.5 percent in Tulsa (Table III-1).

It seems quite clear then that the local sales tax

Table III-1

Relative Importance of Local Sales Taxes in Individual City Tax Structures: 1972

City	Total Taxes	General Sales Taxes	Percent
	($ thousands)		
Birmingham	$ 28,043	$ 7,444	26.5%
Buffalo	86,875	6,260	7.2
Chicago	481,438	68,094	14.1
Dallas	115,042	22,582	19.6
Denver	91,982	37,737	41.0
El Paso	21,524	4,790	22.3
Fort Worth	34,042	8,053	23.7
Houston	126,602	31,689	25.0
Kansas City	78,610	4,425	5.6
Long Beach	35,234	7,934	22.5
Los Angeles	368,143	71,830	19.5
Nashville-Davidson	95,739	21,481	22.4
New Orleans	67,038	27,670	41.3
New York	3,830,557	519,732	13.6
Norfolk	59,806	6,559	11.0
Oakland	45,580	10,079	22.1
Oklahoma City	29,533	11,169	37.8
Omaha	36,951	9,828	26.6
Phoenix	52,157	20,369	39.1
St. Louis	125,035	14,694	11.8
San Antonio	37,371	9,925	26.6
San Diego	57,018	16,627	29.2
San Francisco	239,267	31,888	13.3
San Jose	41,117	9,644	23.5
Seattle	58,816	8,472	14.4
Tulsa	27,501	15,265	55.5

Source: ACIR staff compilation based on *City Government Finances,* 1971-72.

for particular cities can be a highly significant — if not the major — source of local government tax revenue. Denver and New Orleans both raised more than 40 percent of their total taxes from the sales tax while Oklahoma City and Phoenix raised more than 30 percent from this tax source. Eleven cities derived more than one-fifth of their tax revenue from the sales tax — Birmingham (26.5 percent), El Paso (22.3 percent), Fort Worth (23.7 percent), Houston (25.0 percent), Long Beach (22.5 percent), Nashville-Davidson (22.4 percent), Oakland (22.1 percent), Omaha (26.6 percent), San Antonia (26.6 percent), San Diego (29.2 percent) and San Jose (23.5 percent).

Coordinated Versus Uncoordinated Local Sales Tax Systems

At least five criteria can be offered to gauge the degree to which local sales taxes as presently utilized constitute a system of coordinated tax instruments. The most important of these criteria is the conformity of the local tax base to that of the state tax. Of somewhat lesser importance, though highly desirable, are

- universal or widespread coverage of the population by the tax,
- State collection and administration of the tax,
- a local option, within a specified range, as to the tax rate, and
- the establishment of tax liability at vendor location rather than place of customer residence with local use taxes on instate purchases prohibited.

Tax Base

A high degree of conformity between local and state sales tax bases is an essential condition if the deleterious potential of non-property taxes are to be minimized. If the taxable status of various goods and services differs from community to community, it can produce endless confusion, excessive compliance costs for business and significant distortions in consumer shopping habits. This was the case in California prior to passage of the *Bradley-Burns* legislation.

The importance of tax base conformity between local and state sales taxes has been recognized in state legislation. All states permitting local sales taxes have required a high degree of conformity between the local and State tax base. In many cases, in fact, the tax base is identical, though there are examples where relatively unimportant differences in taxable status of certain goods are permitted *(Table III-2).*

Although states authorizing local sales taxes score high on the conformity issue, this does not mean that the tax base utilized by the state is free from criticism. Indeed, if more intensive use is to be made of a given tax base, then issues of the structure and equity of the tax become of increased concern. On these structural questions, the retail sales tax, as a theoretical ideal, ought to (a) be applied to both goods and services consumed by the household sector, (b) exempt all goods and services purchased by the business sector for the purpose of producing items for final sale, and (c) provide an efficient device for reducing the tax payments for those individuals with lesser ability to pay. Recognizing that there are exceptions to each of the following statements, it is nonetheless true that in practice the coverage of services by the retail sales tax is less comprehensive than it could be; that coverage of business purchases is more comprehensive than it need be, and that the devices used to reduce the regressivity of the sales tax are less efficient than they might be.[2]

State Versus Local Administration

Judging by current practice, state, rather than local, administration of local sales taxes is the dominant approach. This is certainly the case with more recently adopted local sales taxes. Minnesota, when it opted for local administration of the Duluth sales tax, was the sole state to choose local over state administration in the past 20 years.[3] Both Alabama and Colorado, while permitting local administration, have instituted procedures for state administration, though these attempts have not been fully effective in inducing the switchover.

Professor Due itemizes the administrative complexities of state administration of local sales taxes:

> While collection of local taxes inevitably creates some problems for the state administration, such as the requirement for localization of sales and additional work for the computer, if they are designed properly, there are few difficulties. But many are not properly designed — particularly when state law allows deviation from the state tax, a choice of rates,

Table III-2

State-Local Sales Tax Systems, Criteria and Performances: July 1, 1973[1]

	Number of Jurisdictions	Tax Base Conformity	State or Local Administration	Local Rate Option	Coverage Jurisdiction	Coverage Population
Alabama	206M*	Parallel or closely	Generally state	YES	57%	B
	25C	Parallel to state tax base	Generally state			
Alaska	78M	No state tax	Local	YES	56	C
	5B		Local			
Arizona	36M	Essentially same as state	Local	YES	58	B
Arkansas	1M	Same as state	State	NO	—	A
California	380M	Same as state	State	YES	95	C
	58C		State		100	
Colorado	89M	Essentially same as state	Local option	YES	35	A
	12C		State		19	
Georgia	2C	Same as state	State	NO	—	A
Illinois	1245M	Same as state	State	YES	99	C
	100C		State		98	
Kansas	3M	Same as state	State	NO	0.5	A
Louisiana	93M	Same as state	Local	YES	34	C
	13P		Local		21	
	49SD					
Minnesota	1M	Same as state	Local	NO	—	A
Missouri	83M	Same as state	State	YES	10	A
Nebraska	2M	Same as state	State	YES	0.2	A
Nevada	10C	Same as state	State	NO	59	C
New Mexico	3C	Same as state	State	NO	9	A
New York	21M	Basically same as state	State	YES	3	C
	44C		State		77	
North Carolina	88C	Same as state	Local Option	NO	88	B
Ohio	28C	Basically same as state	State	NO	32	B
Oklahoma	300M	Same as state	Local option; in practice state administered	YES	57	B
South Dakota	13M	Similar to state	State	YES	4	A
Tennessee	24M	Substantially same as state	State (Optional)	YES	8	C
	85C		State (Optional)		90	
Texas	757M	Substantially same as state	State	NO	86	C
Utah	150M	Substantially same as state	State	NO	70	C
	26C		State		90	
Virginia	38M	Same as state	State	NO	17	C
	96C		State		100	
Washington	260M	Same as state	State	YES	97	C
	37C				95	
Wisconsin	OC	Same as state	State	NO	—	A
Wyoming[3]	OC	Same as state	State	YES	—	A

*M = municipality C = county B = borough P = parish SD = school district

Source: ACIR staff compilation based on data derived from Commerce Clearing House, *State Tax Reporter* and U.S. Bureau of the Census, *1970 Census of Population.*

1 Excluding local sales taxes levied for rapid transit facilities.

2 A indicates less than 50 percent of state population lives in jurisdictions with sales tax.
B indicates that 50-89.9 percent of state population lives in jurisdictions with sales tax.
C indicates that 90 percent or more of state population lives in jurisdictions with sales tax.

3 Two counties now levy a local sales tax.

> and determination of liability on the basis of place of delivery, with accompanying use taxes, rather than on the location of the vendor. Such rules greatly add to complications, lessen the effectiveness of the overall sales tax system, and divert administrative — particularly audit — effort from more significant tasks to the question of which city gets the tax on a particular transaction. The alternative of separate local collection is intolerable in terms of duplicating compliance and administrative effort and the failure of most local governments (Denver is an exception) to do any serious audit work of their own, thus discrediting sales tax operation generally.[4]

Where states administer the local tax, they generally charge for this service — except in Colorado, Ohio and Virginia. Frequently, the charge for administration is the cost to the state or some percentage figure, ranging from 1 percent in Nevada to 4 percent in Illinois. Remittances to localities are generally provided on a monthly basis, less frequently on a quarterly basis and in Washington, on a bimonthly basis. The case for state administration is further strengthened where states have an effective audit program of taxpayers, staffed by professional auditors rather than political appointees.

Continued local administration is undoubtedly due, in part, to strong feelings of local home rule and autonomy. Yet, local administration can result in excessive compliance costs for business and confusion for the consumer, particularly if the quality of administration and enforcement differs among the localities. Granting the persistence of claims for local autonomy, it appears more expeditious to meet this demand by permitting local officials some flexibility in setting the local rate, rather than the option of setting up essentially duplicative tax administrative machinery.

For states with local sales tax administration, the offer of state administration has not proved sufficiently attractive to effect the necessary changes. Essentially, two alternatives are available to the state sector to achieve state administration. The simpler, and more effective is for the state to withdraw the authorization permitting local administration and to mandate state administration in its place. This approach was followed most recently in New York and Virginia and much earlier, 1955, in Illinois. The second approach is to induce, by incentive or coercion, the change to state administration. That state administration provides lower administrative costs is evidenced by New York State experience, even allowing for the complexities of that particular state system of local sales taxes.

> . . . this (tax collection) function must be performed simultaneously for the statewide 3 percent tax and currently for 72 local taxing jurisdictions imposing all or segments of the statewide tax at rates of 1 percent, 1.5 percent, 2 percent and 3 percent. The complexity of this operation can best be illustrated by an example of the type of combination that can exist. One combination involves a county imposing a 2 percent general sales tax, in which is located a city imposing a 3 percent tax on hotel room occupancy and restaurant meals. The same includes a school which imposes a 3 percent tax on consumer utilities. All of this is, of course, in addition to the statewide 3 percent tax.[5]

In addition, state administration in New York is further complicated by differences between state and local tax bases and the use of destination rather than origin for determination of tax liabilities. Despite these features, which make New York one of the least coordinated systems of local sales taxes, ". . . the administrative charges have averaged less than $1.00 per $100 of sales tax revenue considerably less than it costs the localities to administer their own tax prior to August 1, 1965."[6]

Local Rate Option

In sharp contrast to the uniform tax base criterion, variations in local tax rates are far less destructive to the high degree of uniformity sought through the construction of a system of coordinated local sales taxes. Indeed, this is one criterion where the objective of uniformity can be relaxed, either to achieve some other state objective — such as state administration — or simply to foster local initiative and policy making authority.

If rate variations become "extreme", an admittedly vague expression, then distortions in business location decisions and consumer buying habits are likely to result. From a policy making aspect, however, these tax induced distortions are particularly difficult to quantify, depending as they do on several factors, not all of which necessarily produce adverse effects. Most important is the rate differential between the tax imposing jurisdiction and its neighbors — not the rate imposed in any single jurisdiction — in conjunction with consumer-business sensitivity to this rate differential. Working in the opposite direction, however, is the quality and scope of public services offered by the tax imposing jurisdiction *vis-a-vis* its surrounding environs and the fact that there may be compensating differences in some other tax. Moreover, if a tax increase is given, the choice becomes one of alternative tax instruments, rather than between the public and private sector. In this situation, it is the differential business-consumer response to rate variations among communities on each tax instrument that is the appropriate guide.

Despite the existence of potential distortions, it is possible to accommodate the demand for local initiative and at the same time to protect against severe interlocal effects. This can be done by permitting local rate option within a specified range, rather than requiring a uniform local tax rate. Several states do permit at least some option in setting local rates, frequently constraining the local rate within one percentage point — that is, from 0 percent to 1 percent.

A rate differential of 1 percent is not likely to set off any severe response to rate differentials.

Universal or Widespread Coverage

The fourth criterion to achieve uniformity in local sales taxes is to require universal or widespread coverage of the state's local jurisdictions and population by the tax. Obviously, the more extensive the coverage of the tax, the more difficult it is to search out tax free jurisdictions, thereby reducing tax incentives to business location or inducing distortions in shopping habits.

Existing state provisions in this regard show considerable diversity. Some states — such as Arkansas, Minnesota, Missouri, Nebraska, New Mexico and South Dakota — have very spotty coverage, either in terms of jurisdictions or populations subject to the tax. At the other extreme, states such as California, Illinois and Washington have virtually universal coverage.

Vendor Location to Determine Tax Liability

It is also desirable for the state to determine tax liability for local sales taxes according to point of sale or vendor location, rather than place of customer residence. This helps to simplify compliance costs for vendors and avoids an artificial stimulus to the delivery of purchases. Where local taxes are destination taxes, as in New York and Alabama, sellers making deliveries have to ascertain the applicable rate and allocate revenue collected to the correct jurisdiction on each sale for delivery. Further simplification of the local sales tax system will result from prohibiting local use taxes on instate, but not interstate, purchases. Local use taxes on instate purchases can be a major annoyance and a potential source of multiple taxation.

The Border Problem

The fear that a local sales tax will drive consumers to neighboring non-tax or lower tax communites stands out as one of the most basic, and persistent, objections to local sales taxes. This objection has both limited the use of local sales levies and limited the rate imposed. Stated most frequently by retailers, this position is usually countered by tax administrators who claim that the retailers' fears are greatly exaggerated. These divergent viewpoints have been noted by Professor Levin: ". . . it is possible that city retail firms view any sales loss, no matter how small, as a serious one; while the protagonists of the sales tax levy consider that any loss of retail sales — short of a catastrophe — is not significant relative to the shortcomings of alternative forms of taxation."[7]

Empirical Studies

At the outset, it must be emphasized that a number of problems confront empirical research in this area. The above quotation serves to alert policymakers to the fact that the same phenomenon — imposition of a local sales tax — may be viewed differently by different parties. Because such studies have also been time and place specific, it is difficult to generalize from them. For example, as the local sales tax spreads across the state or differences in rates are narrowed, the tax avoidance problem can be expected to be mitigated.

Several empirical studies, using a variety of testing techniques have examined the "border tax" problem. This Commission, in conjunction with the Municipal Finance Officers Association, asked the members of the latter organization the following specific question: "In your opinion, has the

Table III-3

Response to Border Tax Issue, by State: 1972

Question: In your opinion, has the imposition of the local general sales tax by your jurisdiction resulted in the loss of business or altered the shopping habits of individuals to the detriment of your community?

State	Yes	No
Alabama		1
Alaska		6
Arizona		6
California		46
Colorado		13
Illinois		13
Louisiana	1	3
Missouri	2	3
Nebraska		2
Nevada		1
New Mexico		1
New York		5
North Carolina		4
Ohio		3
Oklahoma		6
Tennessee		3
Texas		37
Utah		2
Virginia		11
Washington	2	7
Total	5	173

Source: ACIR-MFOA questionnaire

imposition of the local general sales tax by your jurisdiction resulted in the loss of business or altered the shopping habits of individuals to the detriment of your community?" Of the 178 responses to this question, 173 indicated that there were no material or adverse effects resulting from the imposition of the local sales tax *(Table III-3).* In those cases where the respondents elaborated on their "no" answers, the reason generally cited for the lack of a significant adverse consequence was the absence of a major sales tax differential between the jurisdiction imposing this levy and the neighboring communities.

Although this questionnaire was restricted to local tax officials, it does have the merit of permitting these individuals to assess the economic effects of a local sales tax in conjunction with their surrounding neighborhoods. Other quantitative studies, however, have concluded that some loss of sales did take place. In Denver, Colorado, for example, the study revealed that while there was an initial loss of sales, there was a subsequent return to approximately the pre-tax situation. In effect, this means that consumers eventually did not continue to pursue a tax avoidance policy, though this was their immediate reaction. This result, however, is in contrast to an analysis of the New York City sales tax, where it was concluded that in addition to adverse effects resulting from imposition of the local sales tax, the effects were not later recovered; there is "no evidence for the immediately subsequent periods of any further decline or any recouping of the losses."[8] Two other studies also reached the conclusion that some loss of retail sales did result from imposition of a local sales tax.[9]

Each of these studies pursued the case study approach, thereby making it difficult to generalize the results to other jurisdictions at different points in time. To provide a more general analysis, Mikesell studied 173 central cities of Standard Metropolitan Statistical Areas and concluded: ". . . a 1 percent increase in the ratio of the city tax relative to the sales tax in the surrounding area will cause per capita city retail sales to be between 1.69 and 10.97 percent lower."[10] More significant for the purpose of the present study is Mikesell's subsequent statement: "The result implies much of the sales loss can be eliminated if the area in which the tax applies is widened. Countywide sales taxes produce less sales loss than does a citywide tax."[11]

In its assessment of the border problem, the Special Subcommittee on State Taxation of Interstate Commerce concluded:

> tax saving is most likely to induce crossing the borders for occasional major purchases where the tax can be a significant consideration. While the overall effect on retailing is probably slight, particular stores may be significantly disadvantaged by sales tax

> border effects. But even if the demonstrable effect is slight, it would seem undesirable for the retail merchant to be subjected to this kind of competition.[12]

In sum, while tax administrators do not feel the local sales tax is detrimental, other quantitative studies generally conclude that imposing a new, or raising the rate on an existing sales tax will have at least some impact on at least some retailers. The empirical studies are not in accord as to whether this loss is of a "one shot" nature, with the initial impact being subsequently wiped out in whole or in part. Nor do the few studies providing quantitative estimates reach more than an approximate agreement on the magnitude of the sales tax engendered loss — the range being from 2 percent to 11 percent of per capita retail sales for each 1 percent increase in the ratio of the city tax relative to the sales tax in the surrounding area.

Difficult as it is to pinpoint the quantitative magnitude, there does appear to be agreement that the sharpness of the effect, for retailers and governmental jurisdictions, is reduced as local sales taxes become more widespread and the range in local tax rates narrows. Both these considerations argue strongly for local sales taxes over a wide area (either county levies or statewide) and for a relatively small range in tax rates. Both the border problem and this potential solution find their parallel in the experience of New York State.

> The proliferation of buyer shopping centers, in many cases just across the city line, has been a cause for some concern by officials when the city imposes the tax and the county in which it is located does not. We have no solution to this problem when residents make over-the-counter purchases in the lower tax area. We had hoped that there would be a trend toward county enactment or rate increase, concurrent with repeal of city imposed taxes.[13]

Local Sales Taxes and Fiscal Disparities

A second indictment frequently levelled against local sales taxes is that given unequal revenue raising capacity among local jurisdictions the use of this tax source will exacerbate fiscal disparities. Quite obviously, the local sales tax will be most lucrative for localities possessing concentrations of retail activity; localities that may, or may not, need additional fiscal resources. Indeed, variations in revenues generated by local sales taxes among jurisdictions within a metropolitan area can approach the bizzare. In short, local sales taxes like other taxes (property and non-property) permit each jurisdiction to capitalize on its own fiscal resources — resources that can be distributed quite unevenly throughout a state. Referring to the effects of local sales taxes on different types of communities, Professor Stephens observes:

> The net effect of these proposals is to the advantage of those political subdivisions having a high concentration of retail commercial activity. Residents of balanced, and particularly, the bedroom suburbs would pay out more in sales tax than their communities would receive as revenues from this source. On the other hand, specialized industrial and commercial suburbs would benefit substantially.[14]
>
> * * * * * * *
>
> This tax source favors . . . the core city and the industrial and commercial enclaves, at the expense of the residential suburbs. But retailing is increasingly migrating to the suburbs where its customers reside which could in the near future change the character of this analysis and distribute the proceeds differently. This trend may be further accelerated by fear of crime and civil disorder in the central core.[15]

Data for Los Angeles County amply illustrate the fiscal disparities that arise in certain metropolitan areas. In California, the local sales tax since 1956 has been collected by the state for those counties and cities that agree to conform their tax base to that of the state. While collected by the state, the tax is returned to local governments on an origin or point of collection basis. Sales tax collections per capita among cities in Los Angeles county reveal extreme variations — from \$0.04 per capita in Hidden Hills, \$0.32 per capita in Rolling Hills and \$0.68 per capita in Irwindale; to \$394.45 per capita in Commerce, \$1,071.77 in Industry and a whopping \$12,051.78 per capita in Vernon *(Table III-4).*

Nor are these extraordinary variations in per capita sales tax collections in any sense peculiar to Los Angeles County.

Table III-4

Per Capita Sales Tax Collections in Selected Cities in Los Angeles County

City	Tax Rate (July 1, 1967)	Revenue Distributed	Population (January 1, 1967)	Sales Tax per capita
Artesia	1%	$ 110,881	12,800	$ 8.66
Bellflower	1	842,195	55,550	15.17
Bell Gardens	1	265,672	28,779	9.23
Bradbury	1	590	869	.68
Cerritos	1	87,753	3,523	24.91
Commerce	1	4,181,220	10,600	394.45
Cudahy	1	101,807	14,600	6.97
Duarte	1	98,823	15,000	6.59
El Segundo	1	700,471	16,300	42.97
Hawaiian Gardens	1	83,486	7,975	10.47
Hidden Hills	1	63	1,710	.04
Industry	1	885,280	826	1,071.77
Irwindale	1	554,384	1,518	365.21
La Mirada	1	371,226	26,400	14.06
La Puente	1	378,601	30,250	12.52
La Verne	1	55,575	9,350	5.94
Lawndale	1	238,817	25,200	9.48
Lomita	1	127,169	19,080	6.67
Los Angeles	1	57,107,329	2,779,500	20.55
Monterey Park	1	579,046	50,581	11.45
Norwalk	1	798,289	91,600	8.71
Palmdale	1	146,715	10,785	13.60
Paramount	1	603,268	34,250	17.61
Pico Rivera	1	738,662	51,000	14.48
Pomona	1	1,710,942	85,979	19.90
Rolling Hills	1	609	1,885	.32
Rolling Hills Estates	1	171,347	6,232	27.49
Rosemead	1	304,241	33,412	9.11
Santa Fe Springs	1	1,092,228	16,348	66.81
Signal Hill	1	519,123	6,025	86.16
South El Monte	1	465,634	12,203	38.16
South Pasadena	1	250,809	21,100	11.89
Temple City	1	203,413	40,338	5.04
Vernon	1	2,759,857	229	12,051.78

Source: Robert C. Brown, "Some Observations on the Distribution of the California Local Uniform Sales and Use Tax", *Proceedings of the 61st Annual National Tax Association Conference,* San Francisco, California, 1968, p. 30.

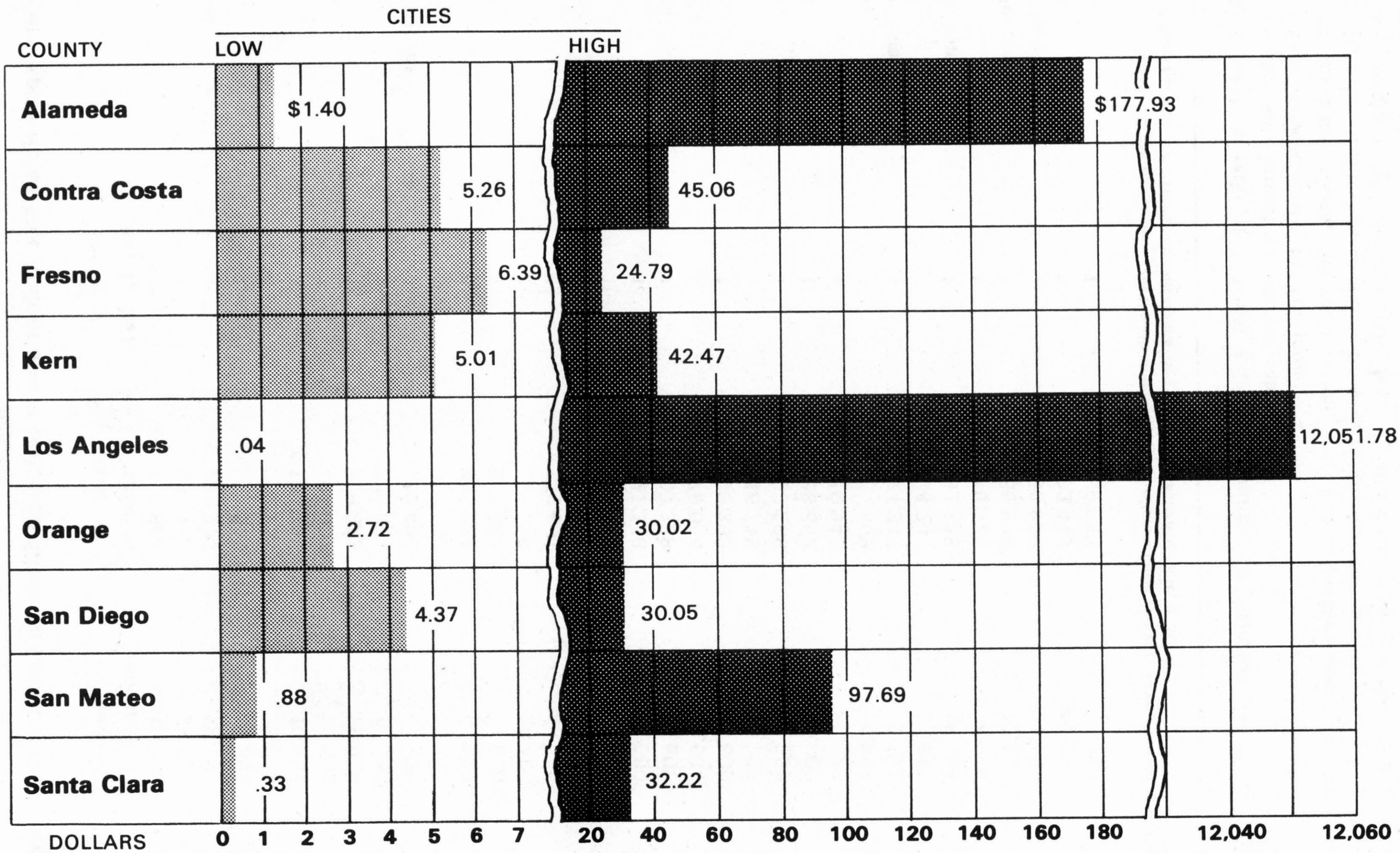
In Alameda County, a ratio of 127-to-1 exists between the highest and lowest per capita sales tax figures; in San Mateo County, the comparable ratio is 111 and in Santa Clara, the ratio is 98 *(Figure III-2).* In other California counties, however, variations among cities are distinctly less severe. There are also less severe variations among counties of different population sizes *(Figure III-3).*

The disparities associated with local sales taxes returned on an origin or point of sale basis have also been noted for the State of Washington. The authors of that study concluded:

FIGURE III-2

Per Capita Local Sales Tax Revenue Among Selected California Counties: 1966-67

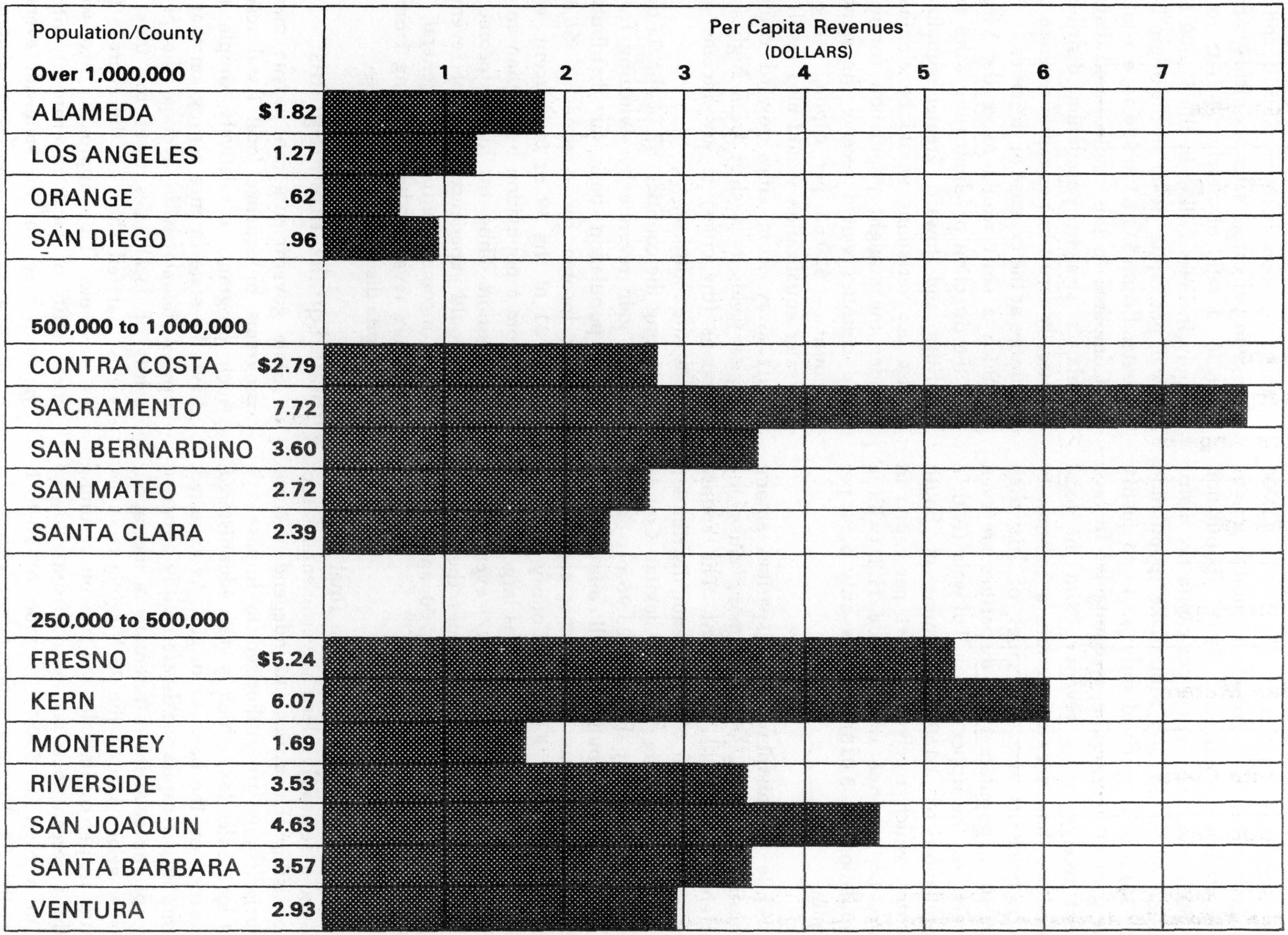
(Low and High Cities)



SOURCE: Robert C. Brown, "Some Observations on the Distribution of the California Local Uniform Sales and Use Tax," ***Proceedings of the 61st Annual National Tax Association Conference,*** *San Francisco, California, 1968, p. 31.*

FIGURE III-3

Local Sales Tax Revenues in Selected California Counties: 1966-67



SOURCE: Robert C. Brown, "Some Observations on the Distribution of the California Local Uniform Sales and Use Tax", ***Proceedings of the 61st Annual National Tax Association Conference****, San Francisco, California, 1968, p. 31*

Perhaps more serious as far as equity is concerned is the range of distributions between cities of comparable size. For instance, the range between cities in the 10,000-45,000 range is substantial. Are there enough unique characteristics between Kent (population 16,805) which receives a per capita tax distribution of $39.57 and Mountlake (population 16,538) which received only $3.49 to justify the present distribution as equitable? In fact, Kent receives more revenue from the local sales tax than does Bremerton, a community over twice its size. For cities of less than 10,000 in population the disparities are even larger. At the upper end is Tukwela (with a population of 3,150) the home of South Center, which receives $206.31 per capita in sales tax revenue while Clyde Hill (with a population of 3,018) receives only $.54 per capita.

While the distributional disparities among counties is not as large as among cities, the differences are still significant. The county with the lowest per capita revenue distribution is Asotin receiving $1.54. Klickitat County receives the largest share at $23.96 per capita. The average distribution for all counties using the local option tax is $5.22 per capita. The dollar receipts of Klickitat County in 1971 ($304,283) were almost twice as large as those of Thurston County ($177,817) even though Thurston County has six times the population of Klickitat County (78,700 and 12,700 respectively)."[16]

The State of Virginia presents a final example. Possessing a relatively clean governmental structure, consisting of counties and independent cities, local jurisdictions are authorized to impose a 1 percent local sales tax, which is state administered, and returned on the basis of origin. As expected, variations in per capita yields are readily apparent but do not approach the differentials of metropolitan Los Angeles. Among the 95 Virginia counties, the range in per capita sales tax receipts resulting from the 1 percent local tax extend from a low of $2.29 to a high of $30.11, a ratio of 13-to-1. Among the 39 Virginia independent cities, the spread extends from $10.55 per capita to $102.41 per capita, a ratio of 10-to-1. Grouping counties and cities into income classes reveals that variations in per capita local sales tax yields differ for cities and counties of roughly comparable incomes (*Table III-5*). For example, among counties with family incomes between $5,500 and $7,500, the range in per capita sales tax yields is from $2.93 to $28.30, a ratio of nearly 10-to-1; for cities with family incomes falling in the $7,500 to $9,500 interval, per capita yields on the origin based formula extend from $11.83 to $56.44, a 5-to-1 multiple.

Compared to this origin based distribution formula, a straight population distribution would generally result in per capita revenue gains for the counties at the expense of the cities.

Such a shift would move the Virginia system in the direction of eliminating sales tax yield disparities and toward greater equalization. Local sales tax variations would be eliminated because under the straight population formula, all cities and counties would receive the same per capita amount — $20.63 per capita, using 1971 data. Greater equalization would also result because the shift away from cities toward counties in per capita yields is a shift from high income jurisdictions (the cities) to low income governmental units (the counties).

Among the counties, 87 of the 95 or 92 percent, would gain revenue by switching from an origin to a population basis of distribution; median family income for counties is $6,879. Among cities, 31 of the 39 or 80 percent, would receive less from a population based than an origin based distribution. Thus, the higher income cities generally would experience a loss of revenue while the lower income counties, in general, would gain sales tax revenues by switching from origin to a per capita distribution.

State Equalization Programs

State governments can pursue many types of programs to equalize local fiscal resources. One such program, a relatively simple type, would have the state finance a program that would level up to the statewide average the per capita receipts of local sales taxes for those units with yields that fell short of the average for the state as a whole. This approach then would permit these units of local government with local sales yields in excess of the statewide average to retain all of their revenue; that is, the program would not power equalize. It would, however, coax the poorer jurisdictions into the sales tax field because their local sales revenues would be supplemented

Table III-5

Variations in Per Capita Sales Tax Yields in Virginia Counties and Cities: 1972

Income Class	Counties: Origin Distribution High	Counties: Origin Distribution Low	Counties: Total Number	Counties: Winners (W) and Losers (L) using population distribution instead of origin distribution	Cities: Point of Origin Distribution High	Cities: Point of Origin Distribution Low	Cities: Total Number	Cities: Winners (W) and Losers (L) using population distribution instead of origin distribution
$ 3,500 - 5,500	$30.11	$ 8.39	5	4W; 1L	—	—	—	—
5,500 - 7,500	28.30	2.93	57	54W; 3L	$ 46.52	$10.55	3	1W; 2L
7,500 - 9,500	24.71	2.29	24	23W; 1L	56.44	11.83	28	4W; 24L
9,500 -11,500	30.03	8.95	7	5W; 2L	102.41	18.76	6	3W; 3L
11,500+	23.59	20.63	2	1W; 1L	75.90	55.22	2	—; 2L
Total			95	87W; 8L			39	8W; 31L

Median County Income: $6,879

Median City Income: $8,813

Sources: Department of Taxation, Richmond, Virginia; Forthcoming in the ***Annual Report of the Department of Taxation To The Governor of Virginia For The Fiscal Year Ending June 30, 1973*** and ***City and County Data Book***, U.S. Department of Commerce, U.S. Bureau of Census, 1972.

by state resources; it would also reduce resource disparities among local governments.

The cost of such a program to the state government depends both upon the distribution of the population and the location of retail activity. For the state government in Virginia, the costs of such a program would have been \$18.4-million, based on 1972 data.

State Redistribution Programs

To be sure, variations in revenues generated are inherent in, but by no means peculiar to, local sales taxes. Due to differences in fiscal capacities, any tax instrument utilized at local discretion will produce unequal per capita yields — as *Serrano* type cases have amply demonstrated.

States can respond to the disparities problem in two ways. First there is the state revenue sharing program designed to equalize all local tax resources or a limited program designed to offset only the variations inherent in the local sales tax system. The second option would have the state distribute sales tax revenues among cities and counties on some basis other than that of origin. That is, the state as the collection agent could "pool" local sales tax revenues and return these among cities and counties on the basis of measures of program needs or relative fiscal capacity. This latter approach could contain two facets — a distribution formula among counties and a distribution formula for constituent units within counties.

Actual Practice

In actual practice, state governments ordinarily do not pursue programs calling for the redistribution of local sales tax revenues. The vast majority simply return the collected revenues on the basis of location of sale; that is, on the basis of origin. Hence, no effort is made to offset the variations in sales tax revenues generated by differences in local government fiscal capacities.

Yet, there are exceptions to this general rule. The State of Wyoming, for example, has a program whereby local governments shared in an increased state sales tax. Beginning in 1967, Wyoming set aside one-sixth of its state sales tax revenues for distribution among counties on the basis of origin and then within counties, to cities and towns, according to population. Thus, while no redistribution was attempted among Wyoming counties, some redistribution did take place among the governmental units within a particular county. The 1973 Kansas legislation, which authorizes county sales taxes, divides the revenue within the county as follows: one-half the revenues to counties, cities and any junior college districts in proportion to property taxes and one-half to the county and to each city in proportion to the non-urban county population and the population of cities. In addition to Kansas, redistribution features are present in Nevada (population), New York (fraction of specified government, population and average daily attendance), North Carolina (property tax collections and population), Tennessee (fraction of specified government and sale location) and Wisconsin (property values and population) *(Table III-6)*. All these programs, it should be noted, call for intracounty redistribution rather than intercounty redistribution.

Despite these exceptions, the general practice is for the state sector to return revenues on the basis of location of sale, a non-redistributive, origin based program which serves to intensify fiscal disparities within a county. It also tends to freeze the existing governmental structure because all local governments are "propped-up" by their access to the sales tax.

An alternative approach that would reduce these objections would call for the division of the revenues among constituent governmental units on the basis of tax effort. From the governmental structure standpoint, this approach is preferable because it removes the disincentive to the transfer of functional responsibilities to a broader based government. A division of revenues on the basis of tax effort will compensate those large local jurisdictions that increase their functional activities and at the same time reflect the diminished responsibilities of the smaller jurisdictions that give up part of their functional responsibilities.

Jurisdictional Overlap

The problem of jurisdictional overlap arises when more than one governmental unit is granted authority to impose the local sales tax and two techniques have been adopted to resolve this issue *(Table III-7)*. Credits are used between cities and counties in California, Washington, and Utah.

Three states — Colorado, New York and Tennessee — employ a "prior rights" system where local governments are given access to specified portions of the sales tax. In Colorado, the county rate takes precedence over the city rate, subject to the constraint that the total city, county and state rate cannot exceed 7 percent; in New York, cities and counties each have prior rights to one-half the maximum rate (currently 3 percent). In Tennessee, the county has prior rights to the maximum rate defined as one-half the state sales tax rate, a feature that has hastened widespread county adoptions.

Tax overlapping does occur between Alabama cities and counties, though several counties do not apply their tax within city limits where the city also uses the sales tax; in Alaska, among municipalities, boroughs and special districts, and among Louisiana municipalities and parishes. In the other states where local sales taxes are authorized, overlapping is avoided either by giving exclusive authority to employ the tax to one type of jurisdiction or by the presence of non-overlapping tax areas.

Summary

In sum, local sales taxes are one means by which state and local governments can further diversify their revenue structures and secure a

Table III-6

Techniques of Local Sales Tax Revenue Allocation

State	Revenue Redistributed[1]	Sale Location	Fraction of Specified Government	Property Tax Collections	Property Values	Population	Average Daily Attendance
Alabama	No						
Alaska	No						
Arizona	No						
Arkansas	No						
California	No						
Colorado	No[2]						
Illinois	No						
Kansas	Yes			X		X	
Louisiana	No[3]						
Minnesota	No						
Missouri	No						
Nebraska	No						
Nevada	Yes					X	
New Mexico	No						
New York	Yes		X			X	X
North Carolina	Yes			X		X	
Ohio	No						
Oklahoma	No						
South Dakota	No						
Tennessee	Yes	X	X				
Texas	No						
Utah	No						
Virginia	No						
Washington	No						
Wisconsin	Yes				X	X	

Source: John F. Due, *State and Local Sales Taxation: Structure and Administration*, Chicago, Illinois, 1971, p. 305.

[1] If revenue is not redistributed, revenue is essentially distributed entirely by sales location.

[2] The referendum for a countywide sales tax can make provision for revenue distribution among the county, its cities and its towns.

[3] Parish tax rates are often divided to benefit school districts, general government, or police juries.

Table III-7

Methods For Dealing With Local Sales Tax Overlapping

State	Jurisdictions with Local Sales Tax Authorization	Method of Local Tax Coordination
Alabama	Municipalities, Counties	Full overlap[1]
Alaska	Municipalities, Boroughs, Special Districts	Full overlap
Arizona	Municipalities	Exclusive authority
California	Municipalities, Counties, Rapid Transit Districts	Local credit[2]
Colorado	Municipalities, Counties	Maximum rate[3]
Illinois	Municipalities, Counties	Non-overlapping areas
Kansas	Municipalities, Counties	Maximum rate
Louisiana	Municipalities, Parishes	Full overlap[4]
Minnesota	Municipalities	Exclusive authority
Missouri	Municipalities	Exclusive authority
Nebraska	Municipalities	Exclusive authority
Nevada	Counties	Exclusive authority
New Mexico	Counties	Exclusive authority
New York	Municipalities, Counties[5]	Maximum rate[6]
North Carolina	Counties	Exclusive authority
Ohio	Counties	Exclusive authority
Oklahoma	Municipalities	Exclusive authority
South Dakota	Municipalities	Exclusive authority
Tennessee	Municipalities, Counties	Maximum rate[7]
Texas	Municipalities	Exclusive authority
Utah	Municipalities, Counties	Local credit
Virginia	Municipalities, Counties[7]	Non-overlapping areas
Washington	Municipalities, Counties	Local credit
Wisconsin	Counties	Exclusive authority

Source: John F. Due, *State and Local Sales Taxation: Structure and Administration,* Chicago, Illinois, 1971, p. 304.

[1]Several counties do not apply their local taxes within the limits of cities with sales taxes (or at half the normal rate within a city police jurisdiction). These counties include: Lauderdale (Florence), Lee (Auburn, Opelika), and Marion (Winfield).

[2]Rapid Transit District taxes overlap in full with city and county taxes.

[3]The total city, county and State tax cannot exceed 7 percent. The county rate takes precedence over a city rate.

[4]Except East Baton Rouge Parish where the parish rate does not apply within the corporation limits of Baton Rouge, Baker and Zachary.

[5]School districts in cities with a population less than 125,000 can request the city to levy a sales tax for school purposes.

[6]The city has prior right to one-half of the maximum rate and the county has prior right to one-half of the maximum rate. The maximum local rate currently is 3 percent.

[7]The county has prior right to the maximum rate, defined as one-half of the State sales tax rate.

more balanced use of taxes on income, sales and property. They offer a major source of revenue at relatively low rates, thus reducing pressures on the traditional source of local revenues, the property tax. While not entirely free of their own problems, particularly the potential for aggravating disparities and distorting shopping decisions, local sales taxes (equipped with the necessary safeguards) can drastically reduce fears on these scores and permit local policymakers the opportunity to choose tax sources that accord with taxpayer preferences.

FOOTNOTES

[1]Urban Observatory, National League of Cities, "City Taxes and Services: Citizens Speak Out", *Nation's Cities,* August, 1971, p. 10.

[2]These structural and equity questions of the retail sales tax are dealt with in the Commission report, *The Value-Added Tax and Alternative Sources of Federal Revenue.*

[3]Minnesota now prohibits other municipalities from enacting local sales taxes.

[4]John Due, "Weak Areas in the Administration of the Sales and Use Tax," *Revenue Administration — 1970,* National Association of Tax Administrators, 38th Annual Conference, Detroit, Michigan, p. 95.

[5]William H. Selden, "Administration of Local Sales and Use Tax—New York," *Revenue Administration—1970,* National Association of Tax Administrators, 38th Annual Conference, Detroit, Michigan, p. 115.

[6]*Ibid.,* p. 118.

[7]Henry M. Levin, *An Analysis of the Economic Effects of the New York City Sales Tax,* Financing Government in New York City, Graduate School of Public Administration, New York University, 1966, p. 636.

[8]William Hamovitch, "Sales Taxation: An Analysis of the Effects of Rate Increases in Two Contrasting Cities," *National Tax Journal,* Vol. XIX, No. 4, December, 1966, p. 471.

[9]L. Maliet, "Illinois Retailers Occupation Tax and Iowa Retail Sales and Use Taxes," Ph.D. Dissertation, University of Illinois, 1955, and Harry E. McAllister, "The Border Tax Problem in Washington," *National Tax Journal,* Vol. XIV, No. 4, December.

[10]John L. Mikesell, "Central Cities and Sales Tax Differentials," *National Tax Journal,* Vol. XXIII, No. 2, June 1970, p. 213.

[11]John L. Mikesell, "Local Government Sales Taxes," Chapter 10, in John F. Due, *State and Local Sales Taxation Structure and Administration,* Public Administration Service, Chicago, Illinois, p. 297.

[12]Special Subcommittee on State Taxation of Interstate Commerce, House Judiciary Committee, *Report on State Taxation of Interstate Commerce,* House Report 565, 89th Congress, 1st Session, Vol. 3., 1965, p. 769.

[13]William H. Selden, "Administration of Local Sales and Use Tax—New York," *Revenue Administration—1970,* National Association of Tax Administrators, 38th Annual Conference, Detroit, Michigan, pp. 117-118.

[14]G. Ross Stephens, *op. cit.,* p. 511.

[15]*Ibid.,* p. 516.

[16]Robert E. Berney and Robert H. MacPherson, *Improving the Distribution of Revenues from the Local Option Sales Tax,* Washington State University, College of Economics and Business, Pullman, Washington, pp. 7 and 8.

Chapter IV

LOCAL INCOME TAXES: INTERGOVERNMENTAL ISSUES

The Philadelphia income tax of 1939 is the oldest municipal income tax still in effect. There were, however, earlier precedents. Charleston, South Carolina, adopted a tax on personal income in the early 19th century but subsequently dropped the levy because of administrative difficulties. New York City in 1934 enacted a municipal income tax but immediately postponed collection; the tax was repealed in 1935 without a return being processed. Thus, the 1939 Philadelphia tax is taken as the starting point of the local income tax movement.

At present, more than 4,200 jurisdictions in ten states have adopted a local income tax. Where authorized, the tax is used by cities and counties; Kentucky school districts and Pennsylvania school systems and townships are also permitted to levy the tax.

Like other local non-property taxes, local income taxes have been utilized to satisfy the need for additional tax revenues without adding to the pressure on the steadily increasing property tax. In part, the growth of these taxes reflects the presence of constitutional and political constraints that have forced local governments into the non-property tax field. Of greater importance, however, is the distinct "rescue operation" or "fiscal emergency" aspect of the local income taxes adopted by the larger cities. Philadelphia, for example, had an outstanding bonded indebtedness of more than $40-million in excess of the constitutional restriction and real estate delinquencies of nearly $25-million when it enacted its 1939 tax. The theme of fiscal distress runs through Cincinnati and Pittsburgh — each of which needed about $6-million to balance their budgets — St. Louis ($8-million) and Detroit ($19.5-million in debt from operations plus a $15-million obligation to its various retirement systems).

The need for an alternative to the property tax has been a key argument in favor of municipal income taxes. Indeed, the "selling" of a local income tax is frequently packaged with a property tax reduction program — examples being Flint and Saginaw, Michigan, as well as Toledo, Ohio. A recent analysis concluded that pressures on property taxes were, in fact, reduced as a result of the adoption of local income taxes.

Income tax cities are characterized by lower property taxes as a percent of total taxes, lower per capita property taxes, and lower per capita total taxes. In addition, both per capita property taxes and per capita total taxes have increased at a lower rate in the income tax cities.

While income taxes usually have been introduced under conditions of severe financial stress, with the primary objective the capture of additional revenue, the evidence suggests that in practice the income tax has to some degree acted as a substitute rather than supplemental source of revenue, and in particular has taken some of the pressure off the property tax.[1]

Based on the results of the Urban Observatory Survey of public attitudes towards taxes, local income taxes generally are preferred to further increases in the property tax if additional tax revenues are needed. At the same time, they run a distinct second to local sales taxes. Aside from Baltimore, where the local income tax was the least preferred of five tax instruments, the income tax was the uniform second choice of citizens in the other nine cities. In three of those nine cities, however, the margin of difference between preferences for the income tax over the property tax was three percentage points or less — Atlanta, 17 percent vs. 14 percent; Boston, 16 percent vs. 15 percent; and San Diego, 15 percent vs. 13 percent. In five cities Albuquerque, Denver, Kansas City (Kansas), Kansas City (Missouri) and Milwaukee — the local income tax was accorded the edge over the property tax by margins of 2-to-1 or more.

In part, the preference for local income over local property taxes undoubtedly represents taxpayer recognition that non-property taxes — both income and sales — can be "exported" to nonresidents. The local income tax, when — as it virtually always is — extended to commuters, broadens the jurisdictional reach of the local jurisdiction and exacts a payment from those who, in the absence of such a tax, would make no direct fiscal contribution to their jurisdiction of employment.[2] To some, taxing non-residents is also justified as a sort of compensating move, particularly by the large central cities to counter balance restrictive zoning practices of neighboring jurisdictions which force the "high cost" citizen to reside in the central city.

Where permitted, most cities also tax corporate and non-corporate business income, the major exception being Pennsylvania cities which are preempted by a State levy from taxing corporate — but not unincorporated — business income. To the extent that the local income tax is not applied to the business sector, commercial and industrial properties, which would contribute to increased property tax revenues, escape local levies on income.

In sum, the need for additional local revenues, high and rising property tax rates, a somewhat greater degree of public acceptance for the income tax than for the property tax, and the desire to tap the non-resident population have all combined to spur the municipal income tax movement.

Local Income Taxes: Extent of Use

Although local income taxes are used in ten states, widespread coverage of the population by the local income tax is restricted to three states — Maryland, Ohio and Pennsylvania. Moreover, the great bulk of the 4,200 plus jurisdictions are located in Ohio (335 municipalities) and Pennsylvania (3,765 municipalities, townships and school systems). As the large number of local jurisdictions in both Ohio and Pennsylvania indicates, the local income tax is used by some of the very smallest jurisdictions as well as some of the largest cities.

Despite the fact that most of the local governments using the income tax are "small," there is a "big city" dimension to this tax. Following Philadelphia, Toledo was the next big city (over 50,000 population) to levy an income tax (1946) one of 11 such cities to adopt the tax between 1946 and 1949 (Table IV-1). An additional 11 large cities imposed income taxes during the decade of the 50s. The local income tax movement picked up additional momentum during the 60s with 26 "big city" adoptions. Since 1969, only Birmingham, Alabama, among cities of 50,000 or more population has adopted a local income tax, though 34 Indiana counties adopted the tax in 1973.

Revenue Significance

In the aggregate, local governments of all sizes and types raised $1.7-billion from local income taxes, or approximately 2.0 percent of total revenues in 1971. Most of the local income tax revenues was generated by cities ($1.4-billion) with county governments accounting for an additional $167-million.

Table IV-1

Chronological Listing of City Income Tax Adoptions (Cities with 50,000 or more Inhabitants in 1970): December 31, 1973

Year	City	Year	City
1939	Philadelphia, Pennsylvania	1964	Kansas City, Missouri
1946	Toledo, Ohio		Penn Hills Township, Pennsylvania
1947	Columbus, Ohio	1965	Flint, Michigan
1948	Altoona, Pennsylvania		Saginaw, Michigan
	Erie, Pennsylvania		York, Pennsylvania
	Louisville, Kentucky	1966	Baltimore, Maryland
	Scranton, Pennsylvania		Chester, Pennsylvania
	Springfield, Ohio		Harrisburg, Pennsylvania
	St. Louis, Missouri		Mansfield, Ohio
	Youngstown, Ohio		New York City, New York
1949	Dayton, Ohio		Wilkes-Barre, Pennsylvania
1952	Lexington, Kentucky	1967	Cleveland, Ohio
	Warren, Ohio		Cleveland Heights, Ohio
1954	Canton, Ohio		Euclid, Ohio
	Cincinnati, Ohio		Grand Rapids, Michigan
	Pittsburgh, Pennsylvania		Parma, Ohio
1956	Covington, Kentucky	1968	Abington Township, Pennsylvania
	Gadsden, Alabama		Kettering, Ohio
1957	Bethlehem, Pennsylvania		Elyria, Ohio
1958	Allentown, Pennsylvania		Lakewood, Ohio
1959	Lima, Ohio		Lansing, Michigan
	Lancaster, Pennsylvania		Lorain, Ohio
1960	Hamilton, Ohio		Pontiac, Michigan
	Owensboro, Kentucky	1969	Reading, Pennsylvania
1962	Akron, Ohio		Wilmington, Delaware
	Detroit, Michigan	1970	Birmingham, Alabama

Source: ACIR staff compilation.

Among the nation's 48 largest cities (excluding Washington, D.C.), 13 utilize the local income tax and raised $1.6-billion in 1972 from this revenue source. Relative reliance on this tax source ranged from a low of 14.2 percent in Baltimore to 78.2 percent of total taxes in Columbus, Ohio (Table IV-2).

The Commuter Contribution

Extending the local income tax to non-residents is a virtual concomitant of adopting the tax source. There are, of course, exceptions — Washington, D.C. and five small Pennsylvania cities (Baldwin Borough, Brantwood, Columbia, Lancaster and Waynesboro) — while school systems in Pennsylvania and Kentucky school districts are not permitted to tax non-residents. Aside from these exceptions, the 4,200 plus local income taxes are levied on non-residents as well as residents.

Extension of the local income tax to non-residents can have a considerable revenue impact because the flow of individuals into the typical central city is about three times the outward movement. Data on the commuter contribution are not readily available, however, because few cities

Table IV-2

Relative Importance of Local Income Tax in Individual City Tax Structures: 1972

City	Total Taxes (in thousands of dollars)	Income Tax (in thousands of dollars)	Percent
Baltimore	229,285	32,483	14.2%
Birmingham	28,043	5,527	19.7
Cincinnati	75,528	43,606	57.7
Cleveland	81,181	38,807	47.8
Columbus	45,024	35,195	78.2
Detroit	268,924	94,473	35.1
Kansas City	78,610	29,106	37.0
Louisville	38,333	21,312	55.6
New York	3,830,557	805,578	21.0
Philadelphia	410,362	256,738	62.6
Pittsburgh	77,281	13,028	16.9
St. Louis	125,035	36,784	29.4
Toledo	33,363	25,002	74.9

Source: ACIR staff compilation based on *City Government Finances, 1971-72.*

keep their books in such a way as to distinguish between residents and non-residents.

In conjunction with the Municipal Finance Officers Association, this Commission asked members of that organization to allocate income tax collections between resident and non-resident populations. Although only a handful of respondents replied to this question, the answers do indicate that the commuter component was generally a substantial portion of revenues collected from residents and in a few instances, greater than revenues collected from "the home folks" (Table IV-3).

Table IV-3

Income Tax Collections from Non-Residents as a Percent of Collections from Residents: 1971

Percent	Number of Jurisdictions
Greater than 50%	3
40.0 to 49.9	3
30.0 to 39.9	1
20.0 to 29.9	2
10.0 to 19.9	2
Less than 10	3
Total	14

Source: ACIR-MFOA questionnaire, 1971.

Coordinated versus Uncoordinated Local Income Tax Systems

Virtually all local income taxes in current use are relatively simple fiscal instruments. The general state practice is to authorize a flat rate applied to earned income, to provide some local option as to the choice of rate, and to allow the tax to be administered locally. Indeed, with two notable exceptions (Maryland and Michigan), local income taxes as presently utilized do not constitute a system of coordinated tax instruments.

Tax Base

The most frequently used local income tax base is "earned income" — that is, wages, salaries, commisssions and other compensation received during the current tax period plus net profits of unincorporated businesses and professions. This is the tax base in Alabama, Missouri, Ohio and Pennsylvania. In Kentucky, this base is used for all businesses, not just the unincorporated. Taken together, these states account for more than 4,100 of the 4,200 plus local income taxes (Table IV-4).

Because the typical local payroll tax does not reach "unearned income" — from dividends, interest, capital gains, estates and trusts, etc. — it deviates sharply from the Federal and state income tax bases. This difference between state and local tax base can be bridged in one of two ways. Michigan in 1964 enacted the *Uniform Local Income Tax Ordinance* both to ensure uniformity among local income taxes within the state and to extend the tax base to unearned income. The New York City tax also includes unearned income and defines the tax base for residents essentially as Federal adjusted gross income (AGI) but with certain modifications (such as the addition to Federal AGI of interest earned on state and local securities and the deduction of interest income derived from United States securities).

Maryland and more recently Indiana achieve conformity between state and local tax base by making the state tax base the effective base for local tax instruments.

Local Rate Option

Judging by current experience, some local option in the choice of tax rates is the dominant pattern for local income taxes. Maryland permits a choice of surcharges, not less than 20 percent nor more than 50 percent, to the state tax while the Indiana legislation permits a choice of rates up to 1 percent. Michigan and Missouri are two states where local officials are not permitted this rate flexibility. In Michigan (except Detroit) and Missouri the rate is set by state statute at 1 percent. In Ohio, voter approval is necessary to exceed the 1 percent rate limit..

A second aspect of the tax rate criteria is the choice between flat and progressive rate structures. Here the general practice is to follow the flat rate approach. Some of the more recent local income taxes, however, use a graduated rate structure. The Wilmington, Delaware, levy, for example, does not apply to income less than $4,000; a tax of 0.25 percent is applied to income from $4,000 to $6,000 while income over $6,000 is taxed at 0.5 percent. The New York City tax also uses a graduated rate structure. Because the Maryland state income tax is progressive, use of the local surcharge automatically introduces progressivity into the local income tax. Progressivity can also be achieved by means of deductions and exemptions.

Table IV-4

State-Local Income Tax Systems, Criteria and Performance

State	Local Jurisdiction With Tax	Tax Base	State or Local Tax Administration	Local Rate Option	Coverage Percent Jurisdiction	Coverage Percent Population
Alabama	5M	Payroll	Local	Yes	1%	1%
Delaware	1M	Payroll	Local	Yes		
Indiana	31C	State Base	State	Yes	33	20
Kentucky	34M 2C	Payroll	Local	Yes	9M 2C	39
Maryland	23C 1M	State Supplement	State	Yes	100	100
Michigan	16M	Earned and Unearned Income	Local	No	3	27
Missouri	2M	Payroll	Local	Yes	-	24
New York	1M	Similar to State	Local	Yes	-	43
Ohio	335M	Payroll	Local	Yes	36	65
Pennsylvania	3,765*	Payroll	Local	Yes	100	100

M - municipality
C - county
* - cities, towns and other local jurisdictions (including over 1,000 school systems).
Source: ACIR staff compilation based on data derived from Commerce Clearing House, *State Tax Reporter* and U.S. Bureau of the Census, *1970 Census of Population.*

The Progressivity Issue

Despite these more recent exceptions, no strong case can be made for use of progressive rate structures in local income taxes. Basically, graduated rates and the use of exemptions are designed to introduce a redistributive element into the local tax structure. This is a function that localities are ill equipped to perform because their limited jurisdictional reach encourages taxpayer avoidance. Redistribution of income is undeniably a function better performed by the Federal government.

Concerns for equity effects of a flat rate local income tax — which are generally centered on their application to low income groups — can be partially resolved by the fact that the actual rates used are low and further mitigated by the inclusion of unearned income to the local tax base. Nor can it be argued that equity is best defended on the basis of progressivity. The introduction of progressivity into the local tax structure via graduated rates requires a defense of a specific graduated structure, with a given degree of progression, rather than a defense of the general concept itself. Seemingly, equity is easiest to defend on the grounds of equivalent rates applied to a broad income tax base.

Further, if the local "piggyback" approach is followed and the state tax is progressive, the use of different local tax rates — as in the case of different flat rate taxes — can raise the possibility of setting an undesirable migration of business and individuals in place. While the use of exemptions to achieve progressivity will require the imposition of higher rates on the remaining taxable income to secure an equivalent yield, it at least partially eases administration of the tax by reducing the number of returns that have to be processed. The use of progressive rates, on the other hand, can complicate administration and does not reduce the number of returns.

Tax Overlapping and the Commuter

Part of the attraction of the local income tax can be found in the fact that it can reach those individuals working in the city but residing elsewhere. Local politicians quite understandably would favor a tax on non-constituents and this may ease their task of "selling" a local income tax. Non-residents voice the "taxation without representation" theme and further support their claims that their purchases of goods and services (if taxes are shifted forward) and their provision of factors of production (if taxes are shifted backward) indirectly compensate for the additional public services necessitated by their employment.

Whether the commuter pays his "fair share" or whether a local income tax is needed for this purpose remains an unsettled issue in the literature. Studies by Lyle Fitch, Julius Margolis and David Davies reach conclusions favorable to the exemption of commuters.[3] Studies by Amos Hawley, Harvey Brazer and Woo Sik Kee support the counter position.[4]

Judging by actual experience, those local governments that are permitted to tax non-residents do. The commuter aspect of the local income tax thus raises a basic point of intergovernmental tension — the apportionment of tax liability between the commuter's area of residence and his area of employment, since he is, at least potentially, taxable in both.

Assuming that the commuter should pay a local income tax to the jurisdiction of employment — an assumption not universally shared — there is still the need to determine the commuter's "fair share." Should the commuter pay a part of all expenditures incurred by the area where he works including the most expensive functions of education and welfare or just those of certain services more or less directly consumed by him? Can the extra costs attributed to the non-resident be isolated fairly well? What is the value of employment opportunity to the commuter? Should not other taxes, such as sales tax on lunch and purchases, be considered as well as other local business and property taxes that are shifted forward to him in the form of higher product or service prices or backward to him in the form of lower return for his factor of production?

Two proposals have been put forward recently to deal with the commuter problem. George Break has suggested that the right of jurisdictions to tax be divided on the basis of time spent by the individual and his family in each (excluding as a practical matter those jurisdictions where the individual and his family have minimal contact.)[5] Refinements could then be made to modify this ratio. Educational expenditures, for example, would be excluded and the interjurisdictional incidence of other taxes would be accounted for. These adjustments, however, raise all the questions posed previously and would make this a complicated procedure in practice; particularly since the interjurisdictional incidence of local taxes is both difficult to compute and will not remain constant as local tax structures are altered over time.

Melvin White carries the time orientation basis of the commuter problem even further. Viewing the commuter as a dual citizen, White suggested that based on his fractional attachment to both area of residence and area of employment, this fraction — in the neighborhood of 50-50 — be applied to all taxes that both jurisdictions levy on residents: "Setting aside legal and administrative problems, this might require that he (the commuter) would pay half of the property tax and half the income tax of his home community and one-half the income and property tax which the city where he works levies on its own full time citizens."[6] Whatever the legal and administrative complexities such a proposal introduces, they would certainly be coupled by intense political opposition. In terms of economic effects alone, the proposal assumes the commuter benefits from all services provided by the city of employment with no explicit consideration of the actual benefits received from particular services or interjurisdictional tax incidence.

Tax Coordination

Back in 1953, when there were only 276 local income taxes, Robert Sigafoos warned that should constitutional or legislative restrictions on the use of local income taxes be removed "then one of the most complicated and confused problems of intergovernmental tax coordination and equity is bound to appear on a major scale. The present limited pattern serves notice that attempts at Federal, state and local tax coordination might be drastically sabotaged if municipal income taxation expands further and if complete authority and control over administration are vested locally."[7] Timely then, this warning is even more relevant now as local income taxes have spread more than tenfold in number.

The actual practice regarding the commuter liability to his area of employment reveals a wide gamut of answers. In those jurisdictions lacking a local income tax, the non-resident makes no direct tax contribution. Where there is such a levy, the commuter is taxed at the same or preferential rates compared to the resident — the rates being applied to income earned (generally wages and salaries) in the area of employment.

Exclusive Tax Situs

To avoid "double taxation" of the commuter, two approaches are possible. The state can declare either the place of residence or the place of employment as the tax situs; this is done in Pennsylvania (aside from Philadelphia) where the jurisdiction of domicile has the exclusive right to tax earnings. Thus, the individual who lives in one taxing jurisdiction and works in another, also with a local income tax, is subject only to the tax imposed by the jurisdiction of his residence. The area of domicile precedence then limits the claim of areas of employment only to indirect payments by the commuter, to the possible detriment of large central cities with their net influx of non-residents. It can also result in a proliferation of income tax levies among suburbs.

The area of employment precedence escapes this problem but at the expense of shrinking the tax base of neighboring communities, thereby requiring higher tax rates in areas of domicile to yield equivalent revenues. Indiana uses a combination of approaches to the commuter problem. Place of residence determines liability if the county of residence adopts the tax. The place of employment determines liability if the residence county does not adopt and the employing county does. If both employment and residence counties adopt the tax, all revenue goes to the county of residence.

In essence, this approach does not deal with the dual nature of the commuter population. Professor Stevens comments:

> Levying the E-tax or local income tax on the basis of the place of residence unduly favors the dormitory suburbs. Rebating a state income tax to the municipality of residence of the taxpayers has the same effect. If place of employment is the basis for levying or rebating such a tax the employer municipalities benefit at the expense of the residential enclave. In fact such a tax gives the specialized industrial and commercial suburbs a double status as 'tax colonies'. . . . It should be pointed out, however, that a tax based solely on the place of residence of the taxpayer returns almost nothing to the highly specialized commercial and industrial municipalities.[8]

Tax Credits

The second approach — the use of tax credits — explicitly recognizes the twin claims of both areas of residence and employment to a commuter's income. The use of the tax credit has evolved both by voluntary agreement among localities (as in Ohio where state law establishes no binding rule on the tax treatment of commuter income) and by state statute (as in Michigan, where mandatory local credits equally divide the commuter's income tax payment between place of residence and employment). Yet, it should be noted that the credit device, as presently used, avoids only the "double taxation" of the same tax source which, given the low local tax rates, may not be the actual threat envisioned by some dual payers. The tax credit device is of no benefit to those commuters who work in high income tax localities but live in high property and sales tax jurisdictions. As Professor Stephens notes:

> Combining residence and employment as the way the proceeds are divided still advantages the specialized non-residential places and without reciprocity places a premium upon living and working in the same political subdivision.
>
> With reciprocity such a tax introduces a rather specialized kind of taxpayer equity, in that he pays taxes to both where he lives and where he works. The amount of equalization of resources that results is negligible. The Michigan system of leving 1 percent on residents and 0.5 percent on commuters works very much like a tax on both residents and commuters with reciprocity. The financially destitute central city is still dependent primarily upon its own resources. It may even promote further suburbanization of industrial, commercial and residential development.[9]

Interlocal Migration Effects

Like other tax instruments — property and non-property — adoption of or increase in the local income tax can lead to individual and business decisions to relocate. This can, but need not, be the result. Because the commuter aspect of the tax extends the reach of the jurisdiction imposing the levy beyond its own boundaries, interlocal tax differentials are less than would be the case if there were no commuter levy, assuming the same rate is applied to resident and non-resident populations.

Migration effects are not eliminated by extension of a local income tax to commuters. Some non-residents may decide to change their place of employment simply as a result of the commuter levy. Moreover, if the commuter is subject to a preferential rate, an incentive is provided to residents to relocate. The critical points to be emphasized, however, are that any additional local tax can have migration effects (not just the local income tax) and that there are many considerations aside from tax differentials that influence the decision to relocate.

While interlocal tax differentials are one of many relevant factors in the location choice — and may be the swing item in some individuals or business decisions — the generally low rates of income taxes at the local level would seemingly not set off any seriously detrimental movement away from the imposing jurisdiction. As one study of the local income tax indicated:

> Other major cities in New York, Pennsylvania, Ohio, Kentucky, Missouri and Michigan have imposed local income taxes without the simultaneous enactment of identical taxes in the surrounding metropolitan area. This disparity has probably resulted in some emigration by city dwellers seeking to escape the local income tax, but the movement has not yet been significant enough to lead to the repeal of local income taxes in the central cities. Three factors have helped to minimize such emigration. First, low rates have limited the incentive to relocate. Second, most local income taxes apply to the income earned in the city, regardless of the worker's residence. Third, particularly in Pennsylvania, suburbs surrounding the central city often follow its lead, quickly imposing comparable local income taxes. Hence the incentive to flee the city for the suburbs has been somewhat reduced.[10]

Consistent with this conclusion were citations from Lexington and Louisville, Kentucky; Cincinnati and Warren, Ohio; and Gadsen, Alabama, indicating no adverse effects stemming from imposition of local income taxes in these jurisdictions.[11] The same finding emerged from a more broadly based ACIR-MFOA questionnaire which specifically asked: "In your opinion, has the imposition of an income tax by your jurisdiction resulted in the loss of individuals or business firms to other jurisdictions?". From the 54 responses to this question, only six indicated an adverse effect while 48 felt the use of the local income tax did not distort location decisions (Table IV-5). Yet, one respondent elaborated on his malaise by stressing that because income and property values are increasing more rapidly in suburban jurisdictions, the presence of a rate limit on the local income tax enabled the more rapidly growing jurisdiction to finance a greater portion of its budget with the income tax. Hence, while there were no serious income tax differentials, the residual burdens placed on the property tax were exacerbated. Another respondent, who felt no loss of individuals or business had occurred due to imposition of a local income tax in his jurisdiction nonetheless went on to add that this potential effect was given serious consideration in the determination of rate increases.

In sum, it appears that while local income taxes have the potential for increasing interlocal tax disparities, the generally low rates of tax and the presence of neighboring local income taxes have prevented this potential from becoming the reality. This is certainly the view of those responding to the ACIR-MFOA questionnaire and is further supported by the fact that no central city, where disparities between city and suburbs are seemingly greatest, has repealed its local income tax. These negative findings on the location influence of local

Table IV-5

Response to Interlocal Migration Issue, by State: 1972

Question: In your opinion, has the imposition of an income tax by your jurisdiction resulted in the loss of individuals or business firms to other jurisdictions?

STATE	YES	NO	STATE	YES	NO
Alabama		1	Michigan	2	5
			Missouri	1	1
Kentucky		2	Ohio	2	28
Maryland	1	1	Pennsylvania		10

U.S. Total: 6 YES 48 NO

Source: ACIR-MFOA Questionnaire, 1972.

income taxes may result from the keen awareness of this potential and the caution taken by local policymakers not to get "too far out of line" with their neighbors. Whatever the sensitivity of individuals and business to tax rate differentials then has been contained by the actual practice of local income taxes.

Local Fiscal Disparities and State Equalization

Maryland is the only state where the local income tax is, in fact, "statewide;" it thus provides a good example of the disparities resulting from this tax source. Median family income among Maryland counties[12] ranges from a high of \$16,708 in Montgomery County to a low of \$5,878 in Somerset, a ratio of 2.8-to-1. Per capita local income tax revenues, due in part to exemptions and the progressivity in the state tax, produce somewhat greater variations — from \$282.06 in Montgomery County to \$65.47 in Somerset — a ratio of 4.3-to-1, among those counties using the 50 percent piggyback to the State tax.

If Maryland were to adopt a program to bring up to the statewide average all those local jurisdictions with below average income tax yields, this equalization action would have cost \$28.3-million, in 1972. In effect, such a program would provide a statewide floor below which no local jurisdiction would be allowed to fall. Thus poor jurisdictions would be provided an incentive to adopt the income tax since their own resources would be supplemented by state funds. Had such a program been in effect — that is, bringing below average jurisdictions up to the statewide average but permitting above average localities to retain all of their collections — the variations in local income tax revenues would have been reduced from their 4.3-to-1 ratio to just under 2.0-to-1 — a differential less than that found for interlocal median family income.

Administrative and Compliance Costs

Administrative costs of a local income tax can be expected to vary with regard to several factors: (1) the introduction of withholding, (2) the complexity of the tax, (3) cooperative tax administration, and (4) the size of the tax base.

Withholding

Basic to the effective enforcement of a local income tax is the ability to withhold the tax at the source. This, of course, has been noted by others: "Without withholding of the tax from wages and salaries, it is doubtful that an income tax at the local level would be feasible;"[13] and "The power to require employers to withhold the tax on wages and salaries is an absolute necessity if a municipal income tax is to be administered effectively."[14]

The commuter aspect of the municipal income tax, however, introduces two problems regarding withholding. Since some residents of an income tax jurisdiction work outside this governmental entity, the power to withhold is not commensurate with the power to tax. As one discussant of this topic has observed:

> Considering the low rates of most of the local income taxes, there is no doubt that the potential administrative costs incurred in the effective enforcement of the non-withheld segments of the tax base would be quite high relative to the revenue produced. The general view is that enforcement efforts vary considerably among local governments and that in some of them the administration of the non-withheld segment leaves much to be desired.[15]

The second withholding problem stems from the fact that cities cannot force agencies of the Federal or state government to withhold employee taxes — whether the employee is a resident or non-resident. This is a particularly sensitive area for the large central cities with their heavy concentrations of Federal and state employees. A permissive state law authorizing local income taxes can, however, ensure withholding from state employees. At present, the Federal government and the cities of Philadelphia, Louisville and St. Louis have inaugurated a program for those employees who live and work in the same jurisdiction and who request Federal withholding. H.R. 8660, which has passed the House, would provide Federal withholding for all taxing jurisdictions with at least 500 Federal employees. This legislation pending in the Senate, covers all Federal employees who live and work in the same state; it excludes, however, the out of state commuter.

Complexity of Tax Structure

Most local income taxes apply a flat rate to earned income, making the local income tax a particularly easy tax to administer. Yet, some of the more recent taxes have abandoned this "payroll" tax introducing some additional administrative difficulties to secure greater tax equity. The use of exemptions and deductions, taxation of unearned as well as earned income, coverage of business income and graduated rates (whatever their equity effects) tends to complicate administration of the tax. These refinements would seemingly add to the case for state administration of the tax or else their restriction only to large units of local government administering their own income tax.

Cooperative Tax Administration

While state administration remains preferable, there are several devices, short of this goal, by which states and localities can coordinate their tax systems to achieve more efficient administration. The use of these devices, however, has not been fully explored. Since many local income taxes are imposed and administered by small governmental units, the extent of coordination of tax information is locally determined. In Pennsylvania, joint collection agreements are specifically authorized and are, in fact, rather common.

State-local sharing of income tax information is another avenue of administrative efficiency where both states and local governments impose an income tax (an avenue that Kentucky and New York specifically authorize). Indeed, the sharing of tax information could well involve all three governmental levels — Federal, state and local.

The use of coordinated local tax bases (as in Michigan) local tax supplements (as in Maryland) or close conformity to the tax base of an upper governmental level (as in New York) also can reduce compliance costs for residents and nonresidents as well as the local jurisdiction in the form of reduced administrative costs.

Size of Tax Base

Fragmentary data suggest that costs of administering a local income tax, when measured as a percent of tax collections, decline with an increase in the size of the jurisdiction and the height of the tax rate. This is not surprising as economies of scale can be expected to spread overhead costs over a broader base and, more simply, because administrative costs need not increase in tandem with the height of the tax rate. Yet, the data are only suggestive, rather than definitive, because it is not possible to hold the previously mentioned factors constant among jurisdictions.

Relative Administrative Costs

Compared to other tax sources, costs of administering local income taxes are relatively high. Estimates for Pennsylvania cities suggest an average administrative cost of 4.5 percent; in Ohio, the figure of 2 percent of collections was derived for a 1 percent tax and 4 percent for a 0.5 percent rate; in Detroit, the figure was 2.2 percent of net revenues; in New York, despite its more complex tax structure, administrative costs were estimated as less than 1 percent, largely owing to exemptions. By way of contrast, Netzer states that "good" property tax administration can be accomplished at a cost of approximately 1.5 percent while Due has found the general costs of administering state sales taxes to be about 1 percent.

Despite the relatively high costs of administration for local income taxes, the costs are not so high as to rule out this instrument as a local government tax source. Where administrative costs do appear "out of line" or "excessive," it is more likely to be the result of insufficient application of established remedial techniques or an excessively complicated tax for a particular jurisdiction rather than an inherent limitation of the tax source.

Summary

Local income taxes, like local sales taxes, are one device by which local governments can diversify their revenue structures. As a broad based tax, the local income tax can produce relatively large amounts of tax revenue at moderate rates, thus relieving pressures on the property taxes. Because local governments operate in an open economy, however, states should accompany authorization of local income taxes with necessary "safeguard" conditions.

FOOTNOTES

[1]Elizabeth Deran, "Tax Structure in Cities Using the Income Tax," *National Tax Journal,* Vol. XXI, No. 2, June 1968, p. 152.

[2]While much of the business component of the local property tax is also exported, this process of exportation is not nearly as "visible" as the local income and sales tax payments made by commuters.

[3]Lyle C. Fitch, "Discussion," *American Economic Review,* Vol. 58, Number 2, 1958, pp. 328-330; Julius Margolis, "Municipal Fiscal Structure in a Metropolitan Region," *Journal of Political Economy,* Vol. 65, No. 3, 1957, pp. 225-236; David Davies, "Financing Urban Functions and Services," in R. O. Everett and R. H. Leach eds., *Urban Problems and Prospects,* Dobbs Ferry, N.Y.: Oceana Publications, 1965, pp. 119-153.

[4]Amos H. Hawley, "Metropolitan Population and Municipal Government Expenditures in Central Cities," *Journal of Social Issues,* Vol. 7, No. 1 and 2, 1951, pp. 100-108; Harvey E. Brazer, "The Role of Major Metropolitan Centers in State and Local Finances," *American Economic Review,* Vol. 48, No. 2, 1958, pp. 305-317; Woo Sik Kee, "Central City Expenditures and Metropolitan Areas," *National Tax Journal,* Vol. 18, No. 4, 1965, pp. 337-353 and "City-Suburban Differentials in Local Government Fiscal Effort," *National Tax Journal,* Vol. 21, No. 2, 1968, pp. 183-189.

[5]George F. Break, *Intergovernmental Fiscal Relations,* The Brookings Institution, Washington, D.C., 1967, p. 50-52.

[6]Melvin T. White, "Economic Evaluation of the Municipal Income Tax" in *Proceedings of the Academy of Political Science,* Volume XXVIII, No. 4, January 1968, p. 42.

[7]Robert A. Sigafoos, "The Municipal Income Tax — A Janus in Disguise" *National Tax Journal,* Vol. VI, No. 2, June, 1953, p. 188.

[8]G. Ross Stephens, "The Metropolitan Impact of Fiscal and Governmental Reforms: A Simple Model of the Metropolis," *The Urban Lawyer,* Vol. 2, No. 3, Fall, 1970, p. 503.

[9]*Ibid,* p. 503-504.

[10]R. Stafford Smith. *Local Income Taxes: Economic Effects and Equity,* Institute of Governmental Studies, University of California, Berkeley, 1972, p. 9.

[11]*Ibid.,* pp. 31-33.

[12]Only those counties using the 50 percent state piggyback are included so as to avoid the effect produced by differences in tax rates; this excluded only two counties.

[14]Milton C. Taylor, "Local Income Taxes After Twenty-One Years," *National Tax Journal,* Vol. 15, No. 2, June, 1962, p. 118.

[14]Charles F. Conlon, "Enforcement of the Municipal Income Tax," in *Proceedings of the Academy of Political Science,* Vol. XXVIII, No. 4, January, 1968, p. 481.

[15]*Ibid.,* p. 482.

CHAPTER 5

USER CHARGE FINANCING

In a market economy, prices serve the dual roles of determining what goods and services will be produced and of rationing the available goods and services among competing bidders. Pure user charges (prices paid for goods and services) potentially serve the same role in the public sector that prices serve in the private sector. Four characteristics of the service or facility to be priced must be examined in deciding whether to levy a user charge for a particular service or facility.

Behavior Modification

One purpose of user charges is to ration what is available in limited supply, influence people to alter behavior drawing on public resources, and restrain the level of consumption to the desired level. Charging the user or beneficiary of a service (or more precisely, the person whose actions motivated the expenditure) compels the individual to take account of the costs that his actions impose on the system. In some cases, use will be very sensitive to the price charged. In the case of some services, however, the amount of use is likely to be the same whether the service is unpriced or priced at full cost.

Indeed, some methods of pricing offer little incentive to alter behavior. When flat charges are imposed, the user pays the same amount regardless of how much he uses the service. For example, if a $3 per month charge is levied on each house for garbage removal or water supply, the occupants have little reason to be careful or moderate in their use of water or their production of trash. If the water charge is levied on the basis of the size of the lot rather than the quantity of water used, then homeowners will not have an incentive to reduce the quantity of water used but will have an incentive to reduce the size of the lot. This is the desirable arrangement if, as Vickrey asserts, cost depends principally upon the length of the pipe that must be laid to reach the user.[1]

Nature of Benefits

In many cases, the very reason for government performance of a function is that the price directed, market economy is inappropriate. Sometimes users are too general or diffuse to be identified, as in trying to assess the beneficiaries of a particular police patrol. Even when immediate users are identified (those persons being immunized against a disease in the case of public health), the ultimate beneficiaries, who were the real reason for public performance of this function, may be someone else and thus too diffuse to be billed. The public at large might benefit in either of two ways: because it is protected from an epidemic and because it derives satisfaction from knowing that the persons immunized are protected. Charging the person to be immunized may make him less willing and thus reduce the benefits to the ultimate beneficiaries.

Administrability

Even when a system of identifying and collecting from users can in concept be created, the actual cost may be high. The waste resulting from employing toll collectors, meter readers, inspectors or other enforcers may outweigh the waste that results from allowing unlimited use of the service or facility. Although general taxes also entail collection costs, an increase in taxes does not entail a substantial increase in collection costs. Creation of a new user charge does. As Adam Smith stated:

> Every tax (or other source of governmental revenue) ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state. A tax may either take out or keep out of the pockets of the people a great deal more than it brings into the public treasury, in the four following ways. First, the levying of it may require a great number of officers, whose salaries may eat up the greater part of the produce of the tax. . . .[2]

On the other hand, an increase in a user charge also does not entail an increase in collection costs. Thus, while administrative considerations may argue for foregoing a possible user charge and thus financing from general revenue, such considerations do not argue for light use of the charge.

Equity

Objections to user charges are frequently made on the grounds that user charges place a disproportionate burden on lower income people. As a general proposition, however, the claim of regressivity is not intuititively obvious or meaningful. For some goods and services, with pricing policies based on exact usage, lower income persons would pay a larger percentage of income than higher income persons; for other goods and services the higher income persons will pay a larger percentage. In this respect, goods and services for which user charges might be imposed are not different from other, privately provided goods. Furthermore, horizontal equity argues that if one person uses a good or service and another equally well off person does not, only the actual user should pay for the service.

As actual pricing practice deviates from exact usage pricing, however, the charges take on an arbitrary character. The extreme case is a charge imposed on all potential users which is the same regardless of the amount of actual use, such as a $3 per month charge per house for water or sewage or trash removal. Such charges are virtually taxes but would generally be subject to criticism as highly regressive if labeled as taxes.

User charges do have the potential for restoring equity in the case of two groups who may use city services but do not pay taxes: tax exempt organizations and non-residents.

Summary of Criteria

John Due summarizes the criteria for evaluating particular use charges.[3]

> The case for charging most or all of the costs against the users is strongest if —
>
> A. Substantial waste of the service will result if it is provided free of charge.
>
> B. The benefits are primarily individual in character rather than benefiting the community as a whole.
>
> C. The prices for the services can be collected easily.
>
> D. The method does not result in burdens on individuals which are considered to be contrary to accepted principles of equity.
>
> In contrast, the case for providing the services free of charge and covering their costs from taxation is strong if —
>
> A. The services are of such nature that little waste will occur if they are made available without charge.
>
> B. The benefits accrue in part to the community as a whole, so that the charging of a price will result in unnecessary restriction of use of the service.
>
> C. Costs of collection of prices are high.

D. The pattern of distribution of burden which would result from charging for the services is one which would be regarded as inequitable.

Frequently, however, the choice is not simply between user charges and taxes, but between (for example) a charge capable of influencing behavior and a charge that can be administered cheaply. Johnson, in his examination of sewer charges, examined several possible types of charges with respect to the above and other criteria. The results showed that whatever charge ranked especially high on one criterion, ranked quite low on another.[4]

Efficient Pricing

Some discussions of user charges assume that user charges would cover the full cost of the service and thus obviate the need to finance that function from taxes. Other authorities question this conclusion.

Frequently, the production and use of a good affects beneficially or adversely someone other than the buyer and seller of the good. Such effects are called externalities. The existence of such external benefits is said to indicate that total benefits exceed total cost and thus that provision should be increased through a partial subsidy.

Many public services require facilities such as roads, airfields, bridges, and sewage plants with a large fixed (initial) cost and a relatively low variable (and thus marginal) cost. The existence of fixed costs is frequently said to require charging a price that is not high enough to recover the cost of the facility. The following is a persuasive presentation of this point of view:

> Consider, for example, the "production" of bridge crossings. Assume, to take an extreme instance, that once the bridge in question is built, all wear and tear is a function of time rather than use, i.e., that there are no additional costs associated with extra crossings. (The bridge is never so full as to give rise to crowding.) The marginal cost to society, in terms of scarce resources, of an additional crossing is zero. It follows — the proposition is mathematically demonstrable, as well as, in this case, intuitively obvious — that the efficient ration price for a crossing is precisely zero. A positive price such as would discourage even a single crossing would cause allocation to be inefficient; there would remain unexploited a costless crossing which could make someone better off without hurting anyone else. Yet it is equally evident that charging a price of zero for crossings will hardly raise sufficient revenue to cover the cost of building the bridge.
>
> To a sophisticated businessman used to running a decentralized multidivision firm all this would not come as too much of a surprise. Not every process in a well run firm should be expected to cover its cost in terms of the right set of internal accounting prices. Total profit is the deciding criterion, and it may be worthwhile for a firm to build a private bridge between its two installations on opposite sides of a river yet charge a zero accounting price for its use by the various decentralized manufacturing and administrative divisions. (Zero would certainly be the right price if a positive accounting price discouraged the use of the bridge while extra use involved no extra cost.) The bridge considered as a separate activity would make accounting losses, yet total company profits would be increased.[5]

Even if the bridge crossings (to continue the above example) were not costless, the same reasoning indicates that the proper charge for a bridge crossing is the associated increment in total cost, and charging by that rule would raise less than the full cost of the bridge. To do otherwise would be to deny use of the bridge to someone willing to pay the entire cost associated with his crossing.

This conclusion that such deficits should be allowed is not unchallenged. Economic analysis generally holds that if all goods are priced at marginal cost, then buyers will seek to purchase and suppliers will provide that combination of goods most desired by everyone. Financing a deficit on the bridge requires taxes, and taxes on other goods will raise their price above marginal cost. Thus efficiency requires balancing the effect of pricing the publicly provided good above its marginal cost against forcing the price of all other goods above their own marginal costs.

Although each user should pay only for the cost of what he consumes, jointly all users should bear the total cost themselves. As a matter of equity, in general, non-users should not have to pay part of the cost. As a matter of efficiency, the market test acts as a check against inefficient projects.

The policy of pricing at marginal cost and financing the deficit from general revenues is often misapplied. If the capacity of the facility will never be fully utilized (i.e., more persons can use the facility at the same time) and if building a less expensive facility with a smaller capacity is impossible then the argument for marginal cost pricing may be applicable. On the other hand, if the capacity is fully utilized at nearly all times, then the additional cost of the larger capacity is one of the costs of providing service to the additional person and efficiency requires that he be charged accordingly. If the capacity is fully utilized on some occasions (peak periods, e.g., "rush hours") and not at others, then there should be two prices: (a) a peak period price high enough to cover the capital costs (the cost of providing the capacity) and the actual operating costs related to the use by the peak period group; (b) a non-peak period price covering only the actual operating costs related to the use by the non-peak period users.

Intergovernmental Constraints

Local governments do not have complete freedom in the selection of user charges. First the state may prohibit certain user charges. Second, the Federal government and most states allow personal deductions for certain major taxes levied by local government but not for user charges and certain use related taxes. This creates a bias in favor of general taxation rather than user charges. Third, Federal revenue sharing and some state programs base aid upon fiscal effort, defined in terms of taxes collected but excluding user charges.

Federal Income Tax Deductions

Since the deductibility of a local tax has the effect of reducing how much the taxpayer actually gives up as a result of a given local tax, this creates a bias against the use of user charges and special assessments. A person who must pay $100 for water, sewage, and fire protection would rather pay it as a property tax than as a set of user charges since paying it as a property tax will allow him a partially offsetting reduction in income tax. The deductibility of the gasoline tax and registration fees based on the value of the vehicle creates a bias against tolls, zone and time passes for use of city streets, and metered use of roads (as well as against license fees levied at a flat rate or upon vehicle characteristics such as weight or engine size).

The bias does not affect all segments of the public. For businesses, both charges and taxes are deductible as an income related expense. More than 60 percent of the income tax filers used the standard deduction and thus cannot deduct taxes and would not be able to deduct user charges.

If the deductibility of taxes and user charges were extended beyond its present scope, the taxpayer would have to keep records for all the various taxes and charges in order to know how much to claim and would have to retain the appropriate receipts for three years to defend himself against IRS challenge. Alternatively, IRS could prepare appropriate tables as is now done for the gasoline and sales taxes. If such tables are to account for local taxes and charges, a separate table would have to be prepared for each jurisdiction in the country — a formidable task.

One possible compromise is to allow the deduction of specific charges and fees related to the place of residence, provided that they are listed on the property tax bill. Such a provision could include any special charges for fire protection, sewers, and garbage. A decision would have to be made about water, gas, and electricity because these services are publicly provided in some places and privately in others. (Water is generally public; gas and electricity are generally private.) Indeed, some people are already deducting user charges billed simultaneously with the tax bill, from failure to read carefully either the local tax bill or the Federal income tax guide.

State Income Tax Deductions

For the same reasons, the state income taxes also create a bias against user charges. Whereas states have the freedom to permit or deny whatever deductions they choose, for the convenience of both taxpayers and state tax collectors, states tend to copy the Federal tax.

Furthermore, the state income tax deduction is of considerably less significance since the state rates are much lower than the Federal rates. The lowest rate in the Federal income tax is 14 percent. Only Delaware and Vermont have any rate higher than 14 percent and that rate does not apply until income exceeds $75,000 and $44,000, respectively.

Federal Revenue Sharing

The *State and Local Fiscal Assistance Act of 1972* (revenue sharing) bases the allotments to units of local government in part upon the amount of tax revenue raised by that unit from its own sources. Taxes for this purpose means "compulsory contributions enacted . . . for public purposes . . ., as such contributions are determined by the Bureau of the Census for general statistical purposes." (Employee and employer assessments and contributions to finance retirement and social insurance systems are specifically excluded.) The term taxes does include some licenses such as for motor vehicles, animal, building, and marriage. It does not include charges for use of airport facilities, or hospitals, parking meter receipts, sewage charges, or taxes on property based on some measure other than value such as area or front footage. Also excluded from taxes are proceeds from publicly owned utilities (including water and electricity) and government owned liquor stores.

Since the amount of tax revenue as defined above, but not user charges, is a factor in the amount of revenue sharing received, some bias is created in favor of using taxes rather than charges to finance government activities. If this bias is a crucial factor and if it is desired to eliminate any bias against user charges, the revenue sharing law could be rewritten to include a larger portion of user charges. The data required for implementing is routinely collected by the Census Bureau. One possible substitute for taxes alone as a measure of fiscal effort is all general revenue, including special assessments, other than the Census classifications "miscellaneous revenue" and interest earnings — plus the surplus from utility operations. Miscellaneous revenue is excluded because it captures only amounts of particular revenue sources — such as Alaskan oil royalties — revenues that are not common sources among state governments.

State Financial Assistance Programs

A number of states have some program of financial assistance to units of local government in which the amount of aid received from the state depends upon the amount of tax revenue raised by the local government. By excluding user charges, these programs also work to bias local governments against user charges.

State Legal Requirements

Sometimes user charges cannot be levied because state law prohibits their use or at least does not specifically authorize it. The prohibition against tuition at public schools is the strongest example of where such a prohibition exists and is generally approved. Also some states specifically forbid supplementary charges for specific items such as books, laboratory and gymnasium equipment, and lockers.

Licenses and fees are generally restricted in amount to what is needed to cover the costs of regulation, except where broader powers have been granted to the local government imposing the charge.[6]

Charging for water, sewage, and garbage would seem to present little difficulty. Charges for road use and fire protection would most likely be regarded as taxes and thus would not be easily imposed without state authorization. For example, even if an excise tax on gasoline were a feasible form of imposing a service charge on road users, most cities could not use it without enabling legislation.

Parking meters are an example of the complex nature of the legality of particular user charges. Parking meter ordinances have sometimes been adjudged invalid because they were instituted as revenue producing rather than regulatory measures. The fee collected is subject to limitations of reasonableness and equality, but may be sufficient to defray the cost of installation, maintenance and supervision of the meters. However, it cannot be in effect a tax for general revenue, except when the city is specifically authorized to levy such a tax.[7] The following quotation indicates more of the complexity:

> Indeed, the view has been taken that the fee which may be charged by the use of parking meters is not necessarily limited to the approximate cost of purchase, maintenance and policing of the meters. Nor is the regulation of parking through parking meters invalidated by an incidental increase in the city's receipts. The parking fee collected through such meters may be fixed at a point where some parking will be discouraged without violating the limitation of reasonableness and equality. Excess revenue from parking meters may be expended to maintain and improve streets and highways, including

streets on which the meters are not located. Or the excess revenue may be used to acquire, construct, improve, maintain and manage parking areas."[8]

Project Grant Requirements

Sometimes a Federal grant program requires or encourages the use of user charges. The *Federal Water Project Recreation Act of 1965* specifies that non-Federal agencies must bear 50 percent of the separable costs allocated to recreation, fish and wildlife investment in Federal water projects and all of the operation, maintenance, and replacement costs thereafter. The non-Federal share can be borne in two ways: (1) payment or provision of land or facilities for the project; or (2) repayment with interest within 50 years, provided that the source of payment be limited to entrance fees and user charges. This amounts to a loan under the condition that user charges be used in the future.[9] The *Federal Water Pollution Control Act Amendments of 1972*[10] provides for grants for the construction of waste treatment plants but requires that the applicant adopt a system of charges to assure that each recipient of waste treatment services pay its proportionate share of the costs of operation and maintenance (including replacement) and make provision for the payment by industrial users of the portion of construction costs allocable to the treatment of industrial wastes.

On the other hand, sometimes a Federal law forbids user charges. Prior to 1973, several airports had imposed boarding fees, generally of $1 per passenger. Challenged in several lawsuits as interference in interstate commerce, the charges were upheld by the Supreme Court.[11] Congress reacted by including a provision in the *Airport Development Acceleration Act of 1973*[12] prohibiting taxes, fees, head charges, and other charges, directly or indirectly levied on persons traveling in air commerce, on the carriage of persons, on the sale of air transportation, and on the gross receipts thus derived. (The law does not prohibit property, income, franchise, or sales taxes, nor does it prohibit rental charges, landing fees, and other service charges levied on aircraft *operators.)*

Implementation Problems

Once a decision has been made to raise more revenue from user charges, many choices still remain to be made: Which department? Which activity? Which fee? How large an increase? Making such decisions generally requires detailed knowledge of the department and service involved or the wholehearted cooperation of the department. One might expect departments that are repeatedly requesting additional funding to point out possible sources of funds, but the opposite seems to be the case. In his study of Oakland, California, Meltsner found the departments generally reluctant and unresponsive when the city managers undertook a study of charges. Some departments did not know what their costs actually were. Some departments did not know why they charge fees.

In Oakland individual departments varied to the extent that they tried to collect fees. The building inspectors recovered 90 percent of costs through charges for permits and inspections in a normal construction year, but when construction slumped revenue declined also while costs continued. The director of the municipal auditorium was considered by Meltsner as the most commercial official on the city payroll. As a matter of professional pride he would have liked to break even, and felt that charities, patriotic organizations and conventions should not be given special rates. However, for him "to break even" meant to cover about 60 percent of operating costs. The recreation department in general wished to provide free services for youth and children. However, the department did try to recover costs on sailing and golf and actually made a profit from one golf course.

The other approach to setting fees, i.e., having non-employees of the department who are very familiar with its operations (e.g., budget analysts) determine the fees and charges, was not explicitly discussed by Meltsner. But the evidence which he accumulated shows little prospect of this approach succeeding. The budget analysts were generally unfamiliar with the details of the department's operations. Departmental requests were cut on the basis of rules of thumb rather than on any concrete knowledge of the proposed expenditure. Such people are unlikely to be successful in determining when a charge should be imposed or increased.[13]

Specific Charges

The remainder of this chapter is devoted to specific user charges and service fees, particularly those which exemplify basic issues or which are promising areas for innovation. Special assessments are among areas for innovation. Special assessments are among areas which are *not* discussed.[14]

Water

There are two aspects of water systems: the supply of the total quantity of water to be used and the distribution (transmission) of the water to the place where used. Supply includes provisions for the collection, purification, and storage of water. Distribution includes the network of pipes to transport the water to individual residences.

Distribution. Because the cost of producing and laying pipe increases only slightly with the cross sectional area (corresponding to the volume of water used) and because a minimum size is required to provide water for fighting fires, the distribution costs for water does not depend very much on the quantity of water used. Because the cost of pipe is generally proportional to the length of pipe, the size of lots that the pipes must traverse to reach the destination is the critical determinant of total distribution costs. Because landowners contribute to this cost by the size of their lots (and by keeping some lots vacant), the efficient method of pricing is to compel the landowners to take account of the costs they impose on the water system by charging according to the size of the lot. Vickrey recommends front footage of the lot rather than areas as the basis of the charge.[15] He does not discuss perimeter and the square root of the area, which both have their merits and limitations. The charge can be made when the pipe is laid or it can be levied on an annual basis.

Supply. The cost of the total quantity of water supplied does depend on the quantity used. Economies of scale in some facilities may indicate decreasing costs, but increasing costs are also present since storage costs rise as the best natural sites for reservoirs are used first and as water must be gathered from greater distances.

A number of different ways of levying charges for water supply are conceivable, ranging from a fixed flat fee on all properties (or all properties within a given class), charging for these services in proportion to the value of the property (indistinguishable from a regular property tax), charging on the basis of some proxy for costs incurred (e.g., using number of water outlets as a measure of use of quantity of water), charging on the basis of some precise measure of costs incurred (metered quantity of water used). Possibilities also include levying fees on a different basis for different classes such as residential, commercial, and industrial. Each system of charges has a different set of effects with respect to efficient allocation of resources and the distribution of income. Charging a flat fee per residence would appear to place a heavier burden on the low income than financing from any likely tax. However, to the extent that taxes and water charges paid by business are involved, no clear conclusion can be made. Charging on the basis of some proxy for use, such as the number and type of faucets and other water outlets will cause people to economize on the number of such outlets while having no appreciable effect on the actual use of water. On the other hand, those who have the larger number of water outlets tend to be the greater users of water and thus this approach has some merit in terms of horizontal equity. Moreover, those who have the larger number of water outlets also tend to be more well-to-do; thus charging on this basis improves the position of the lower income person relative to the flat fee approach.

Metering of water use is superior to the above approaches from both an efficiency and an equity standpoint. It extracts the most from those who use the most water (including water for swimming pools, grass and gardens and other luxury uses), thereby shifting more of the cost to the affluent and at the same time encouraging all to make more restrained use of water. These advantages, however, are somewhat offset by the large administrative costs involved: meters must be purchased and installed in every residence, meter readers must be dispatched regularly to the residences, bills must be mailed, checks examined and deposited. One compromise is metering only industrial and non-residential commercial users (the ratio of administrative costs to receipts is lower for this type of property).

Water utilities do generally charge enough to cover costs. Of the water utilities in 29 of the 48 largest cities for which data was available, only one indicated a net deficit.[16]

Sewer Service

Much that pertains to water systems also applies to sewer systems. Just as water systems can be divided into supply and distribution, sewer

Table V-1

Revenue And Expenditure For Selected Governmental Units Within The 38 Largest SMSAs: Fiscal 1970-71 (Thousands of dollars)

Governmental Unit	Revenue from Sewage Charges	Direct expenditure: Total	Direct expenditure: Current Operation	Direct expenditure: Capital Outlay
Total	492,532	1,368,971	481,959	887,012
Counties[1]	38,223	194,692	42,737	151,955
Cities[2]	249,828	629,636	213,642	415,994
Special districts[3]	78,470	264,496	122,327	142,169
All other	126,011	280,147	103,253	176,894

[1] 1970 population of 100,000 or more.
[2] 1970 population of 50,000 or more.
[3] Identifiable special sewer and multifunction districts.
Source: U.S. Bureau of the Census, *Environmental Quality Control, Finances and Employment for Selected Large Governmental Units,* Fiscal 1970-71.

systems can be divided into collection and disposal (corresponding in reverse order to the components of the water system) and much of the cost analysis and pricing prescriptions of one system relate to the other system as well. The principal difference is that unlike water, cost of sewerage is related to sewage strength. Unfortunately, sewage strength cannot be readily metered and therefore charging on this basis depends upon periodic sampling, a costly and sometimes arbitrary process. Interestingly, the systems tend to differ substantially in the extent that users pay the costs of services.

Water and sewer service not only parallel each other, they interrelate at several points. In general, the amount of water distributed to a structure corresponds to the amount of sewage collected from it. Thus, if metering is employed, the metered use of water is a sufficient proxy for use of the sewer system. Indeed, in general, except where it is desired to measure sewage strength, the sewerage charge can be combined with or piggybacked on the water charge.

The principal exception to the correspondence between water and sewer system use occurs when water is used to water lawns and gardens. For this reason, some municipalities base the sewage charge on winter water usage. However, the difference between summer and winter usage is also due to swimming pools and to greater human usage of water, both of which would properly be reflected in the sewer charge. Furthermore, because the use of water is higher in summer, proper pricing requires a higher water charge in the summer. To place a double surcharge for sewerage on winter use and no surcharge on summer use, results in thwarting peak load pricing.

Sewer service is one area where local governments have generally failed to cover total costs. As Table V-1 indicates, local governments in the 38 largest SMSAs recovered less than 40 percent of costs. This statement may distort the situation in that the table gives information for capital outlay rather than for depreciation. However, it is clear from the table that charges are covering only operating costs, leaving depreciation to be financed from other revenue.

Fire Protection

Fire protection was once organized on a fee for service basis. The Roman Cassius (an associate of Julius Caesar) organized his own fire company and would bargain with the victim of the fire while the fire was raging. Frequently, the victim would choose to sell his possessions to Cassius, who greatly increased his wealth as a result of these fire sales. The alternative to such occurrences has seemed to many to be financing fire companies from public funds (and contributions).

Yet, two feasible means of placing fire protection on a user charge basis exist. One is to simply charge the cost of the suppression of a fire to the person owning the property where the fire originated (known as actual cost pricing). Such a policy need not be viewed as adding one affliction (the bill for services) to another (the loss resulting from the fire). Rather, insurance companies would presumably then include a provision in their fire policies to pay such fire service bills and charge an appropriate increase in their insurance rates. The property owner would then be paying for fire protection in proportion to the likelihood and likely seriousness (as perceived by the insurance company) of a fire originating on his property. Furthermore, the insurance company would gently persuade him to eliminate any hazards having the clear potential of creating a fire.

The other means of placing fire protection on a user charge basis is to have the government adopt the method of the fire insurance company and charge the owner according to the likelihood and likely seriousness of a fire originating on the property (known as expected cost or actuarial pricing). Charging on the basis of expected use does entail some administrative difficulties, since all property which would be charged in this manner would have to be visited by an inspector to gather data on age of building, materials used in constructing it, presence of fire extinguishers and sprinklers, distance from nearby structures, and presence of flammable or explosive materials. Yet many buildings are subject to inspection under the present system.

Either approach would create strong incentives to improve fire safety and thus reduce the amount of fire protection service which the city must actually provide. People who sincerely do not believe that a fire would arise on their property would be taking preventive actions simply to avoid the extra charges. The costs of equipment necessary for fighting fires on special pieces of property (e.g., tall buildings) could be charged to that property.

Both approaches must be sharply distinguished from alternatives that allow the owner to decide (in the expected cost version) whether he wants fire service at all or (in the actual cost version) whether he wants it on that occasion. Owners and others would be expected to report all fires as under the present system.[17]

Trash Removal

The case of trash removal is very similar to the case of water and sewage. Like sewage, trash removal can be divided into collection and disposal. The principal and critical difference is that trash removal is not a natural monopoly.

Techniques are being developed which would make possible the exact measurement of the amount of trash, thus achieving the effects similar to those under metering of water but with smaller administrative costs. Among these techniques is requiring the use of specially marked plastic bags, whose price includes the cost of removing garbage.

Yet, policymakers face a Hobson's choice in charging for trash removal. If the amount charged reflects the amount of trash, people will have an incentive to take into account the effects of their decisions affecting the quantity of trash, such as the choice between returnable and disposable bottles, and to condense the size of a given quantity of trash, thus economizing on truck space. Charging in this way will also encourage disposing of trash in other and potentially undesirable ways. People may choose to abandon their trash in vacant fields, public parks, or other places. (Dennis Smith notes that numerous fires are caused by the dumping of trash in vacant lots.)[18] Even if the person refrains from such obvious littering, he may burn the trash or dispose of it in some other manner environmentally inferior to the public agency's method of disposal.

If the charge does not reflect the amount of trash, the incentive to litter disappears but the merit of a user charge vanishes. The choice is then simply whether the cost of trash removal should be financed with a flat $3 per house per month tax or an *ad valorem* tax that raises the same revenue. Equity and ease of administration would argue for the latter.

One possibility is to establish a number of free collection points to which people can bring their trash, thereby creating an attractive alternative to littering and burning as devices for avoiding charges. People who wish their trash collected at their residence can be charged a fee as described earlier to cover the cost of removing that quantity of trash from their residences. People can even be allowed to contract with private entrepreneurs who will deliver the trash to the public disposal facility.

Either a public disposal facility or public financing is needed to guarantee that trash is disposed of in an environmentally satisfactory manner. Since having free collection points necessitates free disposal for some, private companies would be at a disadvantage if they had to bear the cost of disposal.[19]

Parking Meters

In the typical city, parking meters cost $14 per year to operate and generate gross revenues of $63 per meter per year. The average charge was 7¢ per hour. In cities of 100,000 or more population, the average meter charge was 11¢ per hour for off street parking and for on street parking in the central business district, 8¢ per hour outside the central business district. In spite of higher maintenance costs, the net revenue per meter rises to $83. (See Table V-2.)

Clearly a very profitable operation, it is at the same time an operation clearly capable of producing even more revenue: "Parking revenues for cities total $250,000,000. Not as big as it might be, but still a substantial revenue source. In fact, if you examine parking meter charges, it's a buyer's market every time you put your penny, nickel or dime in the slot," notes the first national study of parking in U.S. cities.[20]

And this increase can be made without any increase in administrative costs since the costs of meters and of collecting from meters remains the same regardless of the rate being charged, aside from a one time cost for converting the meters to the higher rate. Use of the meters should not drop off dramatically as shown by the willingness of many people to pay much higher rates at commercial parking establishments, and this would remain the only available alternative.

Because of the low rates, public parking spaces are generally rationed on a first come basis, thus leading to great waste of time as people arrive earlier to obtain one of the limited number of spaces. Higher prices would make it easier for those most wanting or needing spaces to find them. The revenue from parking meters would also supply valuable information indicating whether additional parking facilities should be provided.

Some cities hesitate to charge much for parking for fear that to do so will drive shoppers from downtown stores. Conceivably, however, availability of parking would be of first importance in a shopper's decision of whether or not to attempt to park downtown and such availability would be enhanced by charges sufficient to discourage workers from occupying all available spaces.

Yet, experience indicates great political obstacles to increasing revenues from parking.

The following event took place in San Diego:

> For some years all went well. . . . Suddenly, in 1961, there was an eruption of popular discontent which, with other causes, led to the

Table V-2

Public Parking Meters: Average Operating Costs, Revenues, and Rates

	Total Cities	Cities by Population Size: 100,000 or More	25,000 99,999	10,000 24,999	5,000 9,999	Less Than 5,000
Annual Maintenance & Collection Costs Per Meter						
Maintenance Cost Per Meter	$ 5	$ 15	$11	$ 6	$ 6	$ 3
Collection Cost Per Meter	9	10	8	8	9	9
Total Costs Per Meter	14	25	19	14	15	12
Annual Gross Revenue Per Meter	63	108	82	68	62	55
Parking Meter Rates						
Average Highest Rates Per Hour	8¢	15¢	10¢	9¢	7¢	7¢
Average Rates Per Hour						
On Street						
In CBD	7¢	11¢	8¢	7¢	6¢	6¢
Outside CBD	7¢	8¢	7¢	7¢	7¢	6¢
Off-Street	7¢	11¢	9¢	7¢	5¢	7¢

Source: William E. Robertson, *National Parking Facility Study*, National League of Cities Washingtin, 1972. Quote from page 5, and 30.

Table V-3

Local Revenue for Streets and Roads: 1970

	Municipalities ($000,000)	Municipalities (percent)	Counties and Township ($000,000)	Counties and Township (percent)
Property Tax	594	19.4	707	24.8
General Fund	993	32.5	388	13.6
Local User Imposts*	96	3.1	50	1.8
Local Non-User Imports	61	2.0	19	.7
Tolls*	93	3.0	24	.8
Parking*	63	2.1	2	.1
Fines*	89	2.9	44	1.5
Miscellaneous	65	2.1	56	2.0
Total Local	2,053	67.2	1,289	45.2
Counties, Townships	87	2.8	—	—
Municipalities	—	—	7	.2
State User Imposts*	828	27.1	1,429	50.1
Other State Imposts	67	2.2	56	2.0
Federal	20	.6	72	2.5
Total Intergovernmental	1,002	32.8	1,565	54.9
Grand Total	3,055	100	2,853	100
*User Related Total	1,169	38.3	1,548	54.2

Source: U.S. Department of Transportation, *Highway Statistics 1971*, pp. 154, 158.

dismissal of Manager George Bean, a man highly regarded in his profession. He had proposed measures to improve the use of parking meters — the installation of meters on certain business streets, an increase in the meter charge, and more stringent enforcement. The council, with only one dissenting vote, approved his plans and he then carried them into effect. The public was furious. Several civic groups at once circulated initiative petitions to secure repeal of the ordinance. When the council refused to put the question on the ballot, a petition was circulated for recall of the mayor. Twenty-five-thousand persons signed it. This was not enough to remove the mayor, but it was more than enough to convince the council that the ordinance needed modification. The popular protest did not end there, however. In the next election, three antiadministration candidates for council (two of whom ran against incumbents) were elected. In part, the vote was directed against City Manager Bean. Many people felt that he was too inflexible. In the fall of 1961, the new council dismissed him.[21]

In the summer of 1961, Mayor Richardson Dilworth of Philadelphia was stoned when he made a speech announcing his intention to levy a substantial charge for parking in the neighborhood.[22]

Streets and Roads

One of the major expenses of most units of local government is the provision of streets, roads, and highways. Such expenditures are generally supported by a combination of general taxation (usually the property tax) and intergovernmental transfers having their origin in motor fuel excise taxes and motor vehicle fees. Consolidated data show that total revenue from highway related sources was only 38 percent of total receipts for roads for municipalities and 54 percent for counties.[23] (See Table V-3.)

Local roads could conceivably be supported entirely by transfers from related state taxes. Two problems exist with this approach. In practice, the formulas for distributing state road funds have been accused of shortchanging urban areas. The Commission has previously recommended that states structure their formulas for allocating the proceeds of highway user taxes among units of local government in such a way as to recognize more adequately urban highway needs and financial ability.[24]

The financing of all roads from state determined revenues is also unsatisfactory because local communities have different physical structures and different tastes. Unless the state is to be in the position of administratively deciding how much roadway each community is to have, the state's role will be a limited one of providing a basic amount for the road system with the local community supplying the remainder from its own taxes and charges.

The issue then arises as to whether general taxation or specific charges (including gasoline taxes) is the most appropriate method of local financing. The question can be partially answered by directing attention to the efficiency, equity, and administrability of the two approaches.

From the viewpoint of efficiency, the most satisfactory situation will prevail if drivers are compelled to take into account (by paying for) the costs of providing the road and the congestion costs (value of loss of time) that they impose on other drivers. In general, there are no external benefits to motivate subsidization and the reason for not financing entirely from user charges (including motor fuel excise taxes) arises from the question of the administrability of such charges. However, an annual flat charge per vehicle is the wrong approach because it will affect the decision to own or not own a car but will not affect the decision to drive or not drive it on a given occasion.

From the viewpoint of equity, the drivers, not the property owners, impose the costs on the city through using the roads. To the argument that the benefit of the roads is to the property owner because the roads supply access to the property and thus make it useable, Vickrey responds as follows:

> To be sure, if conditions are such that the roadway is no more elaborate than that which would be required to provide a mere access, and if traffic conditions are such that there is in fact no interference with other users of the roadway during such "access," then the marginal cost of such is effectively zero in the short run, and charging the entire cost of the access street against the property owner would be conducive to unrestrained use of the uncongested facility, so that efficiency would be served. The bulk of the cost, however, particularly in view of such factors as the use related character of much of the outlay for renewal of pavement and the high proportion of the property values accounted for by the downtown areas, is more nearly chargeable against users than abutting property owners. Even when a vehicle is performing an access function, its impact on traffic and on costs may be substantial; the amount of these costs is a function of the movement of the vehicles performing the access function and is not related in any direct way to the value of the property accessed. While some allowance might legitimately be made for the access function of low traffic residential streets, this allowance would be small. Moreover, even on equity grounds, one could well raise a question as to whether the charge for the provision of common access facilities would not be more fairly allocated according to amount of use, rather than according to the value of the property accessed.[25]

Administrability has been the usual roadblock to user charges for local roads. Consequently, a search has been undertaken to find types of charges which are readily administrable.

Tolls. Tolls are frequently not viewed very favorably. Vickrey, for example, draws a picture of toll booths sprouting everywhere, with congested lines at the booths and the salaries of toll collectors eating up whatever benefits might be derived from improved management of the traffic. Consequently, he recommends the metered usage approach discussed later. Other analysts, such as John Kain, see distinct possibilities for tolls and point out how their application can be improved.[26] He suggests taking advantage of rivers and other barriers that force traffic to be channeled through several selected points. The points can then serve as strategic locations for collecting tolls from all vehicles entering the densest area and thus to cover the cost of the entire system, not the cost of the particular bridge or expressway where the toll booth is located. Furthermore, the time of operation can be restricted to periods of peak flows: collecting from inbound vehicles in the morning, outbound vehicles in the evening, and allowing free use in both directions at midday.

Gasoline Tax. The existing alternative to tolls, the levying of a gasoline tax, encounters special difficulties at the local level. Unless the tax is levied over a fairly substantial area, it is easily avoided by making short side trips for refueling. Furthermore, even if such taxes are levied in all parts of the region, people who live in the suburbs and work in the central city will tend to buy their gasoline in the suburbs and the central city still will not be able to collect revenue from many users of its streets. In only nine states is there an attempt to make use of local gasoline taxes. In most cases the tax is administered by the state together with the state gasoline tax. Hawaii has the most ideal situation for a local gasoline tax since trips form one county to another are, to say the least, difficult; it also has the highest local rates, ranging from 3¢ to 5¢ per gallon. With the exception of Hawaii and one county in Mississippi, the highest local rate is 2¢ and the most frequent is 1¢. Missouri cities, Florida counties, and Connecticut transit districts are permitted to impose a local gasoline tax, but none have done so. St. Louis and Kansas City, however, levy equivalent license taxes of 1.5¢ and 2¢ per gallon, respectively. The tax can be considered widespread only in Hawaii, Alabama, and Nevada. Newark and New York are the only cities in their respective states to use the local tax. (The New York tax, however, applies only to leaded fuel.)

Metered Usage. The difficulties arising from conventional tolls on the one hand and gasoline taxes on the other has led to the development of a number of more imaginative means of charging road users. These ideas include such possibilities as electronic identifiers in cars scanned by roadside equipment (with bills sent out monthly by computer), and meters installed in individual cars so as to be visible from outside or, alternatively, simply activated by pulses emitted from roadside cables. The charges imposed would be related to the extent of congestion existing in the place where the vehicle was, or alternatively, simply to the amount of congestion normally existing at that place at that time of day.[27]

Parking Tax. A less elaborate idea is to charge a fee to users of streets by levying a tax on parking. The principle of this approach is that most people who use streets at times when these streets are congested have recently parked or will shortly thereafter park near such a street. (The obvious exceptions such as taxicabs and delivery trucks can be handled on a separate basis.)

In order to apply to all users of roads, the tax would have to be levied on all parking facilities used by commuters, whether paid for by the user or not and regardless of ownership.

A range of possibilities exist. At one extreme would be a tax on each separate car parked, regardless of time or place. Indeed, the administration can be significantly simplified by basing the tax on the total number of parking stalls available, since this number probably bears a close relationship to peak use of the streets. At the other extreme, the day could be divided into a dozen or more time periods and the city into a number of zones, with the charge for parking depending on the amount of congestion normally existing in that zone at the times that the person arrives and leaves.

Facilities which record the vehicles arrival time and collect their fees at the time the vehicle departs would add to the parking fee the user charge tax appropriate for the two times. Facilities which charge on arrival the same amount regardless of departure times could charge the appropriate tax for arrival and the maximum tax for departure. Users with weekly or monthly rental agreements would have included in their bill the highest tax for arrival and departure. The same procedure would apply to those whose parking is provided free, unless someone is able to provide records of arrivals and departures. Public meters (especially on street meters) could be restricted to non-peak periods.

Designing an appropriate set of charges requires careful balancing of the need to charge adequately the peak period users and to avoid the creation of major problems of administration and enforcement. The more precise the time structure of the tax, the more complicated the tax becomes and the more difficult are both the administration (because it requires keeping track of more categories) and the enforcement (since the parking facility may report one category as another, either keeping the difference between the two rates or passing it on to its customers in its competition for business).

A distinction must be made between parking charges (discussed in a previous section) and a tax on parking. The parking charge applies only to publicly provided places and exists in principle to compensate for the cost of the parking facility.

The parking tax applies to all street users, regardless of where they park, and exists to compensate for the cost of the street system.

Zone passes and time passes. Another approach that is receiving increasing attention is requiring that a special license, permit sticker, or pass be purchased for use of city streets. Under a zone pass system, a high density zone would be specified by posted signs and all cars passing through would be required to have a permit displayed on the vehicle. Several different densities of zones could be specified, each designated by a different color or other symbol, on the signs and on the permits. Under a time pass system, vehicles would be required to have a pass to use the street during peak periods. Again, several different densities of time could be specified. Finally, the two systems could be combined in various ways to achieve any level of exactness if desired, but public understanding and administration would be enhanced by adopting a relatively simple system.

Implementation. With the exception of metered usage, any of the methods of charging highway users could be phased in gradually and at low rates. Indeed, experience with zone passes and time passes could serve as a transition to metered usage, so that public understanding can be increased and so that people will have the opportunity to adjust their lifestyles to the new system.

Cities vary in their authority to charge road users. Some states forbid tolls and others may limit tools on bridges to covering the cost of the bridge and not permit these charges to be used to finance the whole system. Parking taxes may be permitted as a consumer tax under home rule power (as in the Illinois constitution), as a business license in other states, and be prohibited in yet others. Zone and time passes, gasoline taxes, and metered usage are most likely to require explicit authorization.

Effects. Charging higher prices to road users will cause a reduction in road use and less congestion in the area of the taxed parking facilities and on the road leading into such areas. This may take any of several forms. People may switch to other means of transportation, bus, bicycle, or foot. (They may also change the location of their residence to make one of these methods more practical or convenient.) People may combine to travel together in the same vehicle ("car pools"). People who do not need to be downtown full time (shoppers) will rearrange their schedules so that they can accomplish more per trip. If the charge is based on time of day, they will be more inclined to avoid peak periods. People may also shift their place of work or shopping to other locations, the roads to which are not as congested (suburbs).

Licenses and Permits

Permits and licenses are frequently issued to business as a part of a general regulatory process. Generally, they involve an inspection or examination as a condition of obtaining or keeping the permit or license. In many cases, the ultimate beneficiary is the customer of the business obtaining the permit. Thus, the customer should pay the costs and probably does when passed on to him in the form of higher prices. In some cases, the purpose of the charge is to benefit some firms by discouraging new competitors. In this case, charges for permits and licenses are the means by which the government shares in the abnormal profits which it helped create.

Because of the large number of different permits and the relatively modest size of individual fees, local jurisdictions often fail to maintain a realistic fee structure. Because of the continuous increase in the general price level and in real wage rates (both the paperwork and the inspections are very labor intensive in nature), the failure to update fees short changes the local exchequer.

Probably the only simple solution is to have all such fees listed with the finance director who will in turn issue a new fee schedule with an across the board increase in all fees immediately following any across the board increase in city employee wage levels.

FOOTNOTES

[1]William Vickrey, "General and Specific Financing of Urban Services," *Public Expenditure Decisions in the Urban Community* (Howard Schaller, ed.), 1963.

[2]Adam Smith, *The Wealth of Nations*, p. 778.

[3]John Due, *Government Finance*, 1959.

[4]James A. Johnson, "Distribution of the Burden of Sewer User Charges Under Various Charge Formulas," *National Tax Journal* December 1969, pp. 472-485.

[5]Francis M. Bator, *The Question of Government Spending*, 1960, pp. 93-95.

[6]Eugene McQuillin, *The Law of Municipal Corpora-*

tions, Third Edition, Callaghan and Co., Chicago, 1950, Sec. 26.15 ff.

[7]*Ibid,* Sec. 26.167, 26.168, 30.58.

[8]*Ibid,* Sec. 26.168.

[9]Public Law 89-72, as summarized by Jerome W. Milliman, "Beneficiary Charges — Toward a Unified Theory," *Public Prices for Public Products,* pp. 41-42.

[10]Public Law 93-44.

[11]*Chicago Home Rule Commission Report and Recommendations,* 1972, pp. 429-433.

[12]Public Law 93-44.

[13]Arnold Meltsner, *The Politics of City Revenue,* University of California Press, Berkeley, 1971, pp. 71-85, 177-184.

[14]Readers interested in special assessments should see Glenn W. Fisher, *Special Assessments and Financing Public Improvements in the City of Wichita,* Center for Urban Studies, Wichita State University, Wichita, Kansas, 1974. A brief discussion of special assessments is also contained in Tax Foundation, Inc., *Special Assessments and Service Charges in Municipal Finance,* Government Finance Brief No. 20, August 1970.

[15]Vickrey, *op. cit.* (Howard Schaller, ed.), 1963.

[16]*City Government Finances in 1970-71,* Table 8.

[17]One detailed essay on fire protection charges is William Pollack, "Pricing Fire Protection Services," *Public Prices for Public Products* (Selma Mushkin, ed.), 1972, which advocates expected cost pricing. A somewhat different approach is taken by William Vickrey, "General and Specific Financing of Urban Sefvices," *Public Expenditure Decisions in the Urban Community* (Howard G. Schaller, ed.).

[18]Dennis Smith, *Report from Engine Co. 82,* 1972.

[19]The role of trash removal is examined in its context of the environmental system in Judith M. Gueron, "Economics of Solid Waste Handling and Governmental Intervention," *Public Prices for Public Products* (Selma Mushkin, ed.), 1972, especially pp. 200-201.

[20]William E. Robertson, *National Parking Facility Study,* National League of Cities, Washington, 1972. Quote from page 5 and 30.

[21]Edward Banfield and James Q. Wilson, *City Politics,* pp. 182-183.

[22]*Ibid,* p. 185.

[23]For the total domestic highway system, 80.6 percent of revenue was from user related sources.

[24]ACIR, *State Aid to Local Government,* A-34, April 1969. Model legislation to implement this recommendation can be found in *State-Local Finances: Significant Features and Suggested Legislation,* 1971 and 1972 editions.

[25]Vickrey, *op. cit.,* p. 72.

[26]John F. Kain, "How to Improve Urban Transportation at Practically No Cost," *Public Policy,* Summer 1972.

[27]William Vickrey, "Pricing in Urban and Suburban Transport," and Julian Duncan, "Comment," discuss the techniques in detail and argue that they are in fact feasible. *American Economic Review,* May 1963. The British Ministry of Transport has also issued a study, *Road Pricing: The Economic and Technical Possibilities,* Her Majesty's Stationary Office, London, 1964 discussing numerous varieties of such charges as well as the parking tax and time and zone permits discussed below.

Appendix

SUGGESTED LEGISLATION

AUTHORIZATION FOR A LOCAL INCOME TAX SUPPLEMENT TO THE STATE INCOME TAX

This legislation is a supplement to the ACIR model State income tax law.* The definitions, rules, and regulations of the State income tax shall apply to the local supplement except when in the judgment of the State Tax Commissioner, such rules would be inconsistent or not feasible of proper administration.

*This legislation is presented in *State-Local Finances: Significant Features and Suggested Legislation,* 1972 Edition.

Suggested Legislation

(Be in enacted, etc.)

Section 1. Title. This act may be cited as the *Uniform Local Income Tax Law.*

Section 2. Definitions.

(a) "Resident." A resident of a county or eligible city is an individual who is domiciled in that jurisdiction unless he maintains no permanent place of abode in the county or city and does maintain a permanent place of abode elsewhere and spends in the aggregate not more than [30] days of the taxable year in the city or county; or who is not domiciled in county or city but maintains a permanent place of abode in the county or city and spends in the aggregate more than [183] days of the taxable year in the county or city.

(b) "Non-resident." A non-resident is anyone who is not a resident.

(c) "Eligible city." An eligible city is a city of at least 25,000 population as of effective date of tax.

(d) "Persons." (To be defined in conformity with the State income tax code.)

(e) "Taxable year." (To be defined in conformity with the State income tax code.)

Section 3. Authorization.

(a) Any county or eligible city is authorized to impose a local income tax on its residents, and on all other persons earning or receiving income from economic activities carried out in the county or eligible city at a rate not less than [ ] percent of the State income tax liability nor more than [ ] percent of the State income tax liability, provided that the rate adopted is evenly divisible by five. The county shall have the right to preempt a city income tax by adopting a countywide income tax provided that the revenues so raised by the county are shared with all cities of at least [ ] population in the county.[1]

(b) The share for all cities shall be equal to the fraction which total tax revenue raised by all cities within the county represents of the total tax revenue raised by the county and its cities. The share for each city shall be determined by the ratio of the city population multiplied by the fraction represented by the ratio of the county equalized full-value assessment to the city equalized full-value assessment.[2] If the county does not adopt the tax, the authority to enact local income taxes is extended to all eligible cities within the county subject to subsequent preemption by the county.[3]

Section 4. Certification and Withdrawal of the Local Income Tax.

(a) Any county or eligible city enacting an income tax pursuant to this act, shall certify at least [120] days in advance to the [State Tax Commissioner] the effective date of the ordinance imposing an income tax, the rate of the tax for the entire fiscal year, and the date when the enactment becomes effective.

(b) A county or eligible city imposing an income tax within the provisions of this act may repeal its income tax only after first giving at least [120] days notice of the contemplated repeal of its income tax to the State Tax Commissioner. The withdrawal shall be effective from and after the first day of the next calendar year.

Section 5. State Administration of the Local Income Tax. The income tax authorized under the provisions of this act in any county or eligible city shall be administered by the [State Tax Commissioner].[4] Revenues collected under local income taxes shall be accounted for separately and shall be paid into a separate fund to be distributed to the county and eligible cities imposing such taxes after deducting an amount to cover necessary expenditures incurred by the [State Tax Commissioner] in administering the local income taxes. The rules and regulations promulgated in accordance with the State income tax shall apply to the local income taxes except when, in the judgment of the [State Tax Commissioner], such rules would be inconsistent or not feasible of proper administration. The [State Tax Commissioner] is authorized to make any refunds to taxpayers pursuant to this act.

Section 6. Taxation of Local Non-Residents. In the case of the non-resident, the local income tax liability shall be limited solely to his place of employment provided such jurisdiction imposes a local income tax. [Half] of the tax imposed by the jurisdiction of employment shall be credited by the State Tax Commissioner to the non-resident's place of residence provided such jurisdiction also imposes the local income tax. In the event the non-resident lives in a county or eligible city that does not impose a tax but earns income in a county or eligible city that does impose a tax the [State Tax Commissioner] shall credit the total net proceeds of the non-resident's tax liability exclusively to the jurisdiction of employment. In the event the non-resident works in a county or eligible city that does not impose a local income tax, but resides in a jurisdiction which does impose such a tax, the State Tax Commissioner shall credit the proceeds of the commuter tax liability exclusively to the jurisdiction of residence.

Section 7. Credit for Income Tax Paid to Another State or a Political Subdivision of Another State. A resident individual shall be allowed a credit against the tax otherwise due under this act for the amount of any income tax paid by him for the taxable year to another State of the United States or a political subdivision thereof or the District of Columbia on income derived from sources therein and which is also subject to tax under this act.

Section 8. Distribution of Collections Among Local Governments. All sums collected pursuant to this act shall be credited to a special Local Income Tax Fund which is hereby established in the [State Treasury]. After deducting the amount of refunds made, a reserve for expected or anticipated refunds, and the costs of administering the tax, the remaining sums shall be returned by [appropriate State official] to the county or eligible city of origin by the [fifteenth day of the month following the month during which such sums were collected].

Section 9. Separability. [Insert separability clause.]

Section 10. Effective Date. [Insert effective date.]

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[1]If the State does not impose an income tax, counties and cities could be authorized to apply the local tax rates to the Federal income tax base, thereby maximizing taxpayer convenience.

[2]If equalized property tax assessment data are not readily available some other measure of fiscal ability such as income, tax effort or fiscal capacity might be used.

[3]Inter-county equalization of revenues can be dealt with by State programs designed to bring all below average county income tax yields per capita up to the average for the State.

[4]If the State does not impose an income tax, the State (Department of Local Affairs) might be selected to administer the tax.

AUTHORIZATION FOR A LOCAL SALES TAX

This legislation is a supplement to the ACIR model State retail sales and use tax law.* The definitions, rules, and regulations of the State retail sales and use tax shall apply to this supplement except when in the judgment of the State Tax Commissioner such rules would be inconsistent or not feasible of proper administration.

***This legislation is persented in *State-Local Finances: Significant Features and Suggested Legislation,* 1972 Edition.**

Suggested Legislation

(Be it enacted, etc.)

Section 1. Title. This act may be cited as the *Uniform Local Sales and Out-of-State Use Tax Law.*

Section 2. Definitions. "Eligible city." An eligible city is a city of at least 25,000 popula-lation as of effective date of the tax.

Section 3. Authorization.

(a) Any county or eligible city is authorized to impose a local sales tax and a use tax on out-of-State purchases at a rate not less than [ ] percent nor more than [ ] percent. The County shall have the right to preempt a city sales tax by adopting a countywide sales and use tax provided that the revenues so raised by the county are shared with all cities (of at least [ ] population) in the county.

(b) The share for all cities shall be equal to the fraction which total tax revenues raised by all cities within the county represents of the total tax revenue raised by the county and its cities. The share for each city shall be determined on the basis of its population multiplied by the ratio of county equalized full-value assessment to city full-value assessment.[1] If the county does not adopt the tax, the authority to enact local sales taxes is extended to all eligible cities within the county.[2]

Section 4. Conformity to State Sales and Use Taxes. Any sales and use tax law or ordinance adopted under this act shall impose a sales tax for the privilege of selling tangible personal property at retail and a use tax upon the storage, use or other consumption of tangible personal property purchased out-of-State[3] for storage, use, or consumption in the political subdivision. Any sales and use tax adopted pursuant to this act shall be identical to all relevant sections of the State sales and use tax codes. [Statutory citation of the State sales and use tax law.]

Section 5. State Administration. The [State Tax Commissioner] shall administer local sales and use taxes adopted under this act. He may prescribe forms and rules and regulations in conformity with this act for the making of returns and for the ascertainment, assessment, and collection of the tax imposed pursuant to this act, and for the orderly transition necessitated by preemption of city sales taxes by a county. The [State Tax Commissioner] shall keep full and accurate records of all monies received and distributed under this act and is authorized to make any refunds to taxpayers pursuant to this act.

Section 6. Distribution of Collections. All sums collected on behalf of a particular political subdivision pursuant to this act shall be credited to a special local sales and use tax fund which is hereby established in the [State Treasury]. After deducting the amount of refunds made and the costs of administering the tax, the remaining sums shall be returned by the [appropriate State official] to the county or eligible city of origin by the [fifteenth day of the month following the the month during which such sums were collected].

Section 7. Separability. [Insert separability clause.]

Section 8. Effective Date. [Insert effective date.]

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*This legislation is presented in *State-Local Finances: Significant Features and Suggested Legislation,* 1972 Edition.

[1]Or some other measure of fiscal ability such as income, tax effort or fiscal capacity.

[2]Intercounty equalization of revenues can be dealt with by State general fund transfers designed to bring all below average county sales tax yields per capita up to the average for the State.

[3]The Legislature may wish to authorize a local use tax on automobiles purchased within the State.

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