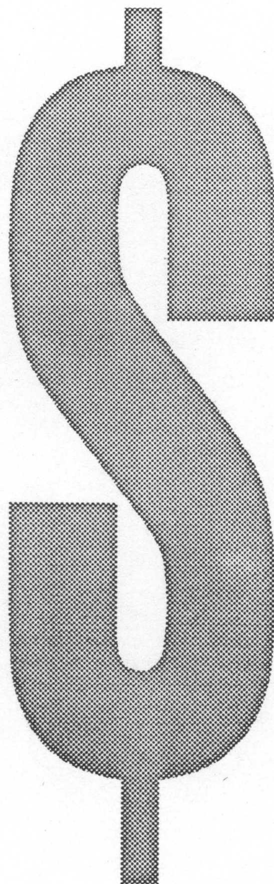
A STAFF REPORT



Local Revenue Diversification

Local Income Taxes

Advisory Commission on
Intergovernmental Relations

SR-10
August 1988

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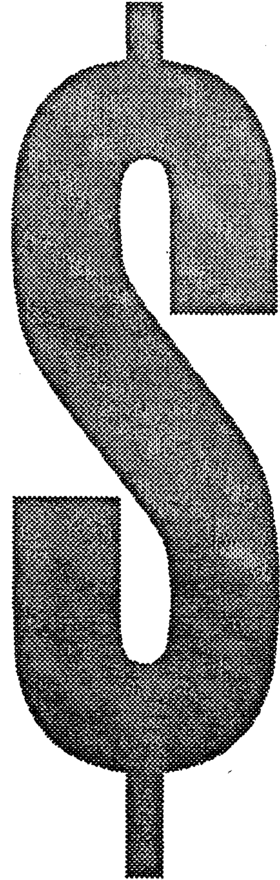

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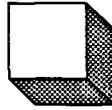


Introductory Notes

This study is one of a series done by staff and consultants of the Advisory Commission on Intergovernmental Relations on ways in which local governments can lessen their reliance on property taxes by diversifying their revenue bases.

For many years, the local property tax has been the fiscal mainstay of local governments, and it remains their major revenue source. Its dominant role has been due to its many virtues as a revenue raiser: for local governments it is easily enforced because a tax on land and buildings is virtually impossible to evade or avoid; it is capable of generating large amounts of revenue; rates are easily adjusted; and its ad valorem character makes it the only tax presently employed in the United States that taxes unrealized capital gains. While this last characteristic is popular with tax administrators, it makes the levy unpopular with those who must pay the property tax, and it can create a serious burden for the elderly and low-income homeowners and farmers.

Given the acknowledged strengths of the property tax as a revenue raiser, why should local governments wish to resort to other types of taxes? One of the most important reasons is that the inflation of the late 1970s emphasized a major shortcoming of the property tax. Because it taps unrealized capital gains, it is capriciously related to the flow of cash into taxpayers' pockets. As inflation sharply increased land values, property tax bills increased, and taxpayers became increasingly irate and fearful that steadily rising property taxes would force them to sell their homes. The passage of Proposition 13 in California in 1978 marked the most dramatic effort to shield homeowners by capping property taxes.

Another reason for diversifying revenue sources is to gain added protection over the course of the economic cycle. At times when property tax revenues lag, they can usually be supplemented by revenues from the more elastic local income and sales taxes. When local income and sales

tax receipts reflect drops in economic activity, the much more stable property tax provides a reliable stream of revenues.

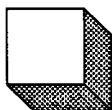
The basic political and economic reasons for diversification of local tax systems lie in the fact that there is no such thing as a perfect tax. Each major tax has unique strengths and weaknesses. The more intensively any tax is used, the more obvious its defects become and the less obvious its virtues. For example, the property tax scores high marks for the reasons cited above: ease of enforcement, fine tuning, and the ability to tax unrealized capital gains. However, when the tax on real property is raised too high, it is widely perceived as a threat to home ownership and a deterrent to certain types of capital intensive business development. In the same way, the local sales tax has the advantage of being convenient, usually paid out in small increments, difficult to avoid, and levied on consumption rather than savings: however, it also is widely perceived as being regressive and as creating an unfavorable business climate. Personal income taxes can be designed to make allowances for individual circumstances of the taxpayer, and they are not regressive, but the automatic response of the tax to inflation has created wide public resentment. A local income or wage tax also may cause taxpayers to move out of the jurisdiction and thus avoid the jurisdictional reach of local government. User charges have the advantage of providing a direct way to link private benefits to public costs incurred; however, too heavy a reliance on user charges can hurt low- and moderate-income families.

The lesson is clear; an efficient and equitable local revenue system should rely on a well-balanced and diversified set of taxes. In addition to avoiding the problems created by excessive reliance on any single tax, a balanced and diversified revenue system may create a more favorable business climate, lessen taxpayer discontent, and provide for stability of revenue throughout the course of the business cycle.

Professor Holley Ulbrich of Clemson University prepared this report on local income taxes. The author wishes to thank John Fava, John Gambill, Steven D. Gold, Robert Inman and Robert Schwab for their extensive and constructive comments on this study. At ACIR, John Shannon, the former Executive Director, was responsible for the initiation of this series of studies. We are grateful for his continuing active role in developing and reviewing the reports. Susannah E. Calkins took major responsibility for supervising the preparation of the report and incorporating the comments of reviewers. Joan Casey edited the report. Mary Dominguez typed the numerous revisions.

This is a Staff Research Report. It is designed to provide information on local income taxes, but does not present any new ACIR recommendations.

John Kincaid
Executive Director



Contents

Introduction 1

Figure 1 Use of Local Income and Payroll Taxes, by Type of Jurisdiction, 1988 2

Types of Income and Wage Taxes 5

Figure 2 Comparative Analysis of Four Types of Local Income Taxes 6

History and Usage 9

Development of Local Income Taxes 9

Current Usage 10

Table 1 Major Features of Local Income and Payroll Taxes—1988 11

Table 2 Local Government Revenues, 1950-86 13

Table 3 Local Income Taxes as a Percentage of Local Revenues, Selected States, Fiscal Year 1986 14

Rates 14

Table 4 City Revenues from Local Income Taxes, 1984-85 15

Revenues 16

Geographic Distribution 16

Design Issues and Safeguards 17

Earned Income or All Income? 18

State or Local Collection? 19

Universal or Local Option? 20

Rate Uniformity or Rate Diversity? 20

Rationales 21

The Benefit Principle 21
Ability to Pay 23
Diversification of the Tax Structure 24
Property Tax Relief 25

Evaluation 29

Yield 30
Elasticity and Stability 30

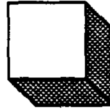
Table 5 Estimates of the Income Elasticities of the Major State-Local Taxes, All States, Various Years, 1965-86 31

Administrative/Compliance Costs 32
Equity Aspects 33
Tax Situs: Residents or Workers 34
Locational Effects 34
Relation to State and Federal Income Taxes 35
Public Receptivity 36

Summary and Conclusions 37

Notes 39

Bibliography 43



Introduction

Local revenues can be diversified and heavy reliance on the property tax can be avoided by adding nonproperty taxes to the revenue base of a local government. Among the most potentially important of the non-property taxes suitable for use by local governments is the local income tax. At present, it is a modest source of local tax revenue, but it is important for a number of large cities.

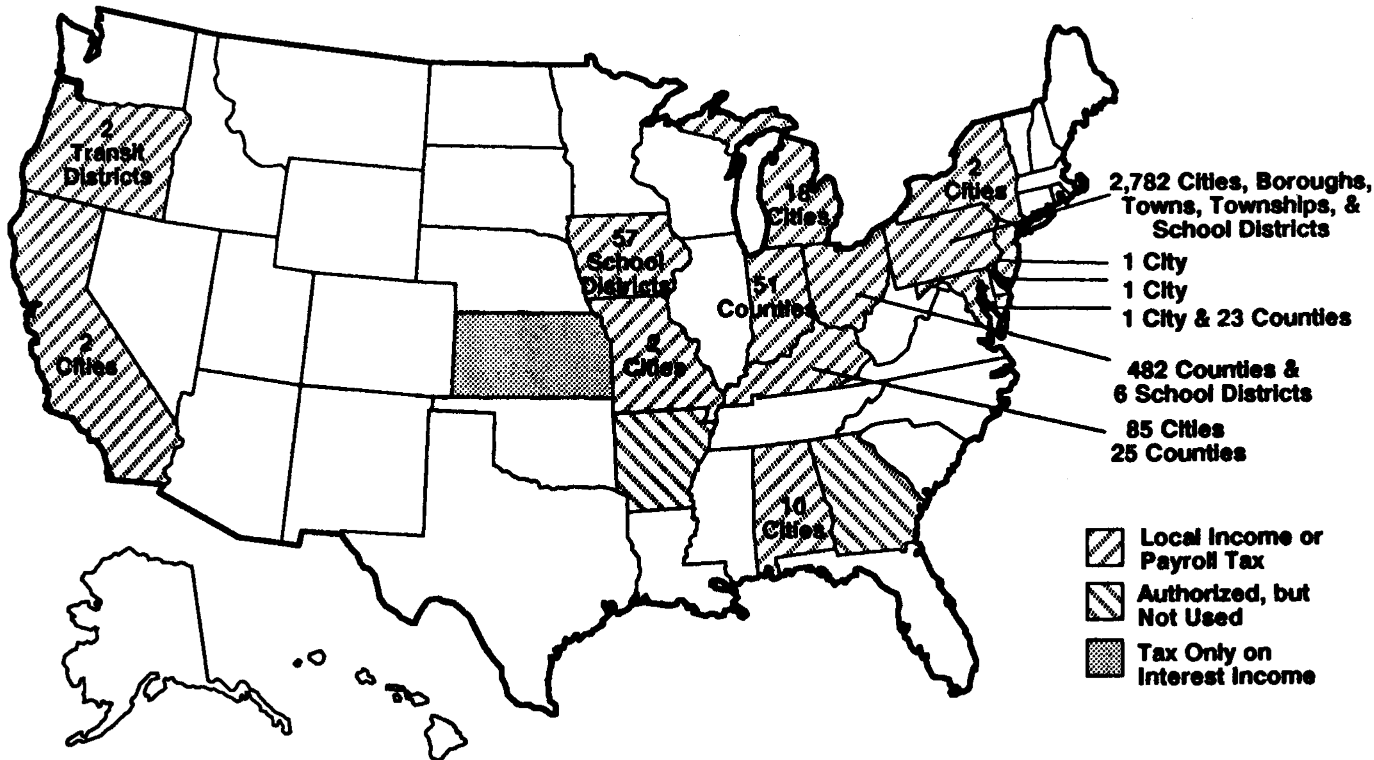
Local nonproperty taxes have five objectives: (1) to obtain additional revenue while avoiding higher property taxes, (2) to broaden the distribution of the local tax burden to include more of those who benefit from local public services, (3) to make the tax structure more flexible with respect to local circumstances, (4) to make the tax structure more responsive to rising costs and service demands, and (5) to reduce relatively high tax rates in overlapping jurisdictions, all of which employ the property tax.[1] Local income taxes can address all of these objectives, but they are most often levied in order to avoid greater dependence on the local property tax, traditionally the mainstay of local government revenues, and to tax those who work in the central city but live in the suburbs.

In 1987, a total of 3,550 local government units—primarily cities, but also boroughs, towns, townships, counties, school districts, and transit districts—levied some form of income, wage, or payroll tax (see Figure 1 for the states where these units are located).[2] Nationwide, personal income taxes rank third in local tax revenue, behind property and sales taxes (general and selective combined).[3] Although nationally the local income tax accounts for only 5.9 percent of all local tax revenues, in the states where they are used, local income taxes yield from 3.8 percent (Alabama) to 28.9 percent (Maryland) of local tax revenues, and from 1.7 percent to 20.7 percent of all local own-source revenues.[4]

In most states local governments are required to have authorization from the state legislature to impose an income or payroll tax. That

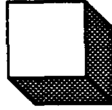
Figure 1

USE OF LOCAL INCOME AND PAYROLL TAXES, BY TYPE OF JURISDICTION, 1988



authorization usually dictates the form of the tax, the permissible range of rates, and the treatment of nonresidents. Local income taxes are most often authorized for use by general purpose local governments, although Iowa, Ohio, and Pennsylvania also allow school districts to use them.

Typically, the income tax is an alternative rather than a complement to a local sales tax. Only five states (Alabama, California, Missouri, New York, and Ohio) use both local income or wage taxes and local sales taxes, and there are actually only seven cities that levy both—Birmingham, Alabama; Los Angeles and San Francisco, California; Kansas City and St. Louis, Missouri; and New York City and Yonkers, New York. Ohio, which authorizes both types of local taxes, limits the income tax to cities and the sales tax to counties. All states that authorize a local income tax also have a broad-based state income tax.[5]



Types of Income and Wage Taxes

There are basically three varieties of local income or wage tax: (1) the wage or payroll tax, (2) the piggyback tax, and (3) the locally designed, broad-based income tax. (See Figure 2, which gives a brief description of local income and wage taxes in the various states where they are used.) The most common is the payroll tax, also known as the wage tax or the earned income tax. This tax is levied at a single flat rate. It is usually collected by payroll withholding, so it is a tax on wages and salaries only rather than on total income. For local governments in three states (California, Oregon, and New Jersey), the payroll tax is legally imposed on employers rather than employees. Economic theory suggests that the legal incidence may have no relationship to the actual distribution of the tax burden between employer and employee and that a part of the burden will fall on each. The distribution of the burden depends on how costly it is for employers and employees to relocate in order to avoid the tax, and how competitive the markets are in which they buy and sell.

Unlike the federal income tax and most state income taxes, the payroll tax typically has no exemptions, deductions, or filing of tax returns by the taxpayer. The administration is thus simple, but not always equitable. Payroll taxes tend to be at least slightly regressive, much more so than most income taxes, because they make no allowance for the different circumstances of different households. Some form of a payroll tax is used by local governments in 9 of the 14 states presently employing local income or payroll taxes: Alabama, California, Delaware, Kentucky, Missouri, New Jersey, Ohio, Oregon, and Pennsylvania. (While California, New Jersey, and Oregon do not identify their taxes as income taxes, their local taxes on income are sufficiently similar to the payroll tax used in other states to justify treating them in the same fashion.)[6] Local income taxes in Michigan are also of this type, except that used by the city of Detroit.

Figure 2

COMPARATIVE ANALYSIS OF FOUR TYPES OF LOCAL INCOME TAXES

	Local Wage or Payroll Tax	Local Income Tax Tied to Federal or State Tax: Percentage of State Income Tax Liability	Local Income Tax Tied to Federal or State Tax: Flat Rate on Federal Adjusted Gross Income	Locally-Designed Progressive Tax
Examples of Usage	**1A** Most common: found in nine of 14 states using local income taxes.	**1B** Maryland Counties	**1C** Indiana Counties	**1D** New York City
General Characteristics	**2A** Flat rate on wages and salaries, no exemptions, no deductions.	**2B** Includes the exemption and deduction pattern of the state income tax; also has the broader definition of taxable income set forth in 2B.	**2C** No exemptions or deductions *but* has a much broader definition of taxable income than set forth in 2A.	**2D** Locally set exemptions and deductions patterned on broad definition of income.
Tax Base	**3A** It does not tax all forms of income. It also fails to shield subsistence income from taxation.	**3B** Taxes all forms of income. It also shields subsistance income from taxation.	**3C** It taxes all forms of income. However, it fails to shield subsistence income from taxation.	**3D** Taxes all forms of income. It also shields subsistence income from taxation.

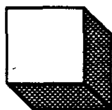
		4A	4B	4C	4D
Taxpayer Compliance Requirements		*Minimal:* Only self employed have to file returns.	*Fairly Light:* Just one added calculation on the state income tax return.	*Fairly Light:* However, all taxpayers must file a simplified return.	*Heavier:* More calculations required.
		5A	**5B**	**5C**	**5D**
Revenue Stability	Revenue Yield During Periods of Economic Growth	Will grow automatically at same rate as the community's wage and salary base.	Will grow automatically at a somewhat faster rate than the growth in the community's income.	Will grow automatically at same rate as the community's income.	Will grow automatically at a somewhat faster rate than the growth in the community's income.
		6A	**6B**	**6C**	**6D**
	Revenue Yield During Periods of Economic Recession	Will decline automatically at same rate as the community's wage and salary base.	Will decline automatically at a somewhat faster rate than the drop in the community's income.	Will decline automatically at same rate as the drop in the community's growth.	Will decline automatically at a somewhat faster rate than the drop in community's income.

The second variety, used in Indiana, Iowa, and Maryland, and in the cities of Detroit, Michigan, and Yonkers, New York, is tied to federal or state income taxes. The local taxes are based on either adjusted gross income or on state tax liability. Iowa and Maryland have broad-based, moderately graduated state income taxes, and the local income taxes in those states (computed as a percentage of state taxes) share those characteristics. Detroit and Indiana county income taxes are based on federal adjusted gross income rather than state income tax liability. Administration is simplified by tying the tax liability directly to the state income tax or to federal adjusted gross income. Therefore, this tax can be relatively inexpensive in terms of both administrative costs and taxpayer compliance costs. Because this type of tax uses a broader income base than wages or payrolls, it tends to be less regressive. Applying a flat rate to adjusted gross income tends to be roughly proportional, while a local income tax computed as a percentage of state income tax liability is more progressive because it taxes all forms of income and incorporates deductions and exemptions.

Tying a local income tax to either a state income tax or federal adjusted gross income results in a tax that has significantly different characteristics than a payroll tax. Among them are a broader base, the possibility of exemptions and deductions and a graduated rate structure, coverage of a different set of taxpayers, and different administrative and compliance characteristics.

The third type of local income tax is that employed by New York City, which is unique: a broad-based tax similar in structure to the New York State personal income tax, utilizing the same deductions and exemptions, but having its own progressive rate schedules.[7] This tax is very similar in structure, although differing in specifics, to the progressive income taxes of New York State and other states. Prior to 1976, New York City residents had to file separate city returns; now they are able to make the computations on their state forms, but there are still differences in the income base and other features that raise taxpayer compliance costs.

Table 1 identifies the important features of local income taxes and the extent of their use. The table also includes the two states in which such taxes are authorized but not presently used, as well as Kansas, which taxes only interest.



History and Usage

Local income, wage, and payroll taxes have been employed since the first enduring one was adopted by the city of Philadelphia in 1938 under enabling legislation passed in Pennsylvania in 1932. (A local income tax was instituted in Charleston, South Carolina, in the nineteenth century, but was quickly abandoned.)[8] These taxes are still far less important in the local revenue structure than property taxes or than either local sales taxes or fees and charges.

Development of Local Income Taxes

The movement to diversify local revenue sources received its first major impetus during the Great Depression. Land values and income from real property were falling far more rapidly than property tax burdens, and foreclosures to pay property taxes were increasingly common. Hostility toward the property tax, combined with pressing expenditure demand to meet the needs of the unemployed, forced local governments to look for other ways of raising revenue.[9]

Initial adoptions took place in response to fiscal pressures: Philadelphia (1938), St. Louis (1948), Cincinnati (1954), Pittsburgh (1954), and Detroit (1962) all adopted local income taxes. There was a wave of adoptions in the late 1960s and the 1970s, again primarily in cities, for the purpose of providing property tax relief, diversifying the local revenue base, and extracting revenue from suburban residents who worked in the central city. The wave of adoptions has peaked, however, and the potential for further adoptions does not appear to be great in the near future unless additional states pass enabling legislation. Even where the state permits local income taxes, these levies have been widely adopted in only three states.

From the first local income tax in Philadelphia until 1962, all the local income taxes adopted were of the earned income/payroll type. In

1962 the first local income tax tied to the state income tax was adopted in Detroit; state authorization was not required because Detroit is a home rule city. As other Michigan cities began to follow suit, the state, in order to impose some uniformity, enacted a statute in 1964 that authorized cities to adopt local income taxes. The Detroit tax remains unique among Michigan's local income taxes, with a higher rate and a base that is essentially federal adjusted gross income.[10]

The third type of local income tax was adopted in 1966 in New York City. Although the city's definition of taxable income was similar to the federal definition, the city adopted its own progressive rates instead of a fixed percentage of the federal or state tax liability.

In 1967, the Maryland legislature adopted the nation's only mandatory local income tax, requiring Baltimore City and every county to levy a local income tax on residents. The legislation gave the counties authority to set a county rate within the range of 20 percent to 50 percent of the taxpayer's state income tax liability. Nineteen of the 24 jurisdictions have chosen the 50 percent rate. To date, this is the only state where the income tax does not have a local option regarding the actual imposition of an income tax, although there is local leeway with respect to rates.

More recent state authorizations of the local income tax in New Jersey (1971), Georgia (1974), and Oregon (1975) have gone back to the local payroll model rather than the piggyback type or locally designed, broad-based income tax. To date, however, only two transit districts (encompassing four counties) in Oregon, and one city in New Jersey have enacted local income taxes under these authorizations. No local jurisdiction in Georgia has elected to impose an income tax.

Current Usage

Today, local income and payroll taxes are used by about 3,550 local governments in 14 states: Alabama, California, Delaware, Indiana, Iowa, Kentucky, Maryland, Michigan, Missouri, New Jersey, New York, Ohio, Oregon, and Pennsylvania. These taxes are also authorized in Georgia and Arkansas (see Table 1). In addition, Kansas taxes only interest.

In terms of sheer numbers, local governments in Pennsylvania are the biggest users of the local income tax—approximately 2,800 of the 3,550 total local governments with such a tax. Pennsylvania authorizes use of the local income tax by cities, boroughs, towns, townships, and school districts. Ohio has the next largest number of users, with 482 cities and 6 school districts. Maryland also has relied heavily on the local income tax; it is used by all 23 counties and the city of Baltimore, and produces a significant share of their revenues. In the remaining states authorizing local income or payroll taxes, an estimated total of 121 cities, 76 counties, 57 school districts, and 2 transit districts employ such taxes (see Figure 1).

In 1970, local income taxes produced 4.2 percent of total local government tax revenues. In 1986, that proportion had risen to 5.9 percent

Table 1

MAJOR FEATURES OF LOCAL INCOME AND PAYROLL TAXES—1988

State	Number of Local Governments With Tax	Range of Rates	Type of Tax	State or Local Administration
Alabama	10 Cities	1%	Gross Receipts (= earned income)	Local
Arkansas	None (only cities may use)	—	Percent of State Income Tax (residents only)	Either
California	2 Cities: San Francisco and Los Angeles	0.75-1.5%	Payroll	Local
Delaware	1 City: Wilmington	1.25%	Payroll/Earned Income	Local
Georgia	None (available to counties; cities if county does not use the tax)	1%	Percent of State Taxable Income	State
Indiana	51 Counties	0.5-1% residents; 0.25 nonresidents	Federal Adjusted Income	Local
Iowa	57 School Districts	4.25-10% on residents	Percent of State Income Tax	State
Kentucky	85 Cities 25 Counties	1.0-2.5%[1] residents; 0.5-2.2% nonresidents	Payroll/Earned Income	Local
Maryland	23 Counties One City: Baltimore	20 to 50% (all but 4 use 50% of state income tax liability)	Percent of State Income Tax	State
Michigan	17 Cities	1.0-2.0% residents; 0.5-1.0% nonresidents	Payroll	Local
	Detroit	3% residents 1.5% nonresidents	Federal Adjusted Gross Income	Local
Missouri	2 Cities: Kansas City and St. Louis	1%	Payroll	Local
New Jersey	1 City: Newark	0.75%	Payroll[2]	Local

Table 1 (cont.)

MAJOR FEATURES OF LOCAL INCOME AND PAYROLL TAXES—1988

State	Number of Local Governments With Tax	Range of Rates	Type of Tax	State or Local Administration
New York	2 Cities:			
	New York City	Residents: graduated to 3.5%; Nonresidents: less than 1%	Income Based	State
	Yonkers	Residents: 15% Nonresidents: 0.5%	Percent of State Tax Liability Earned Income	State
Ohio	482 Cities	1.5-2.25% (most often 2%)	Earned Income[3]	Local
	6 School Districts	0.25-1.0%	Earned Income	Local
Oregon	2 Transit Districts (encompassing 4 Counties)	.5-.6%	Payroll	State
Pennsylvania	Cities, Boroughs, Towns, Townships and School Districts—Total: 2,782 estimated	up to 1%; Home Rule Cities: up to 2%; Philadelphia 4.96%;[4] Pittsburgh 4.0%[5]	Earned Income	Local
Estimated Total Users: 3,550				
Exhibit:				
Kansas	Counties	0.125-0.75%	Interest Income Only	Local
	Cities	0.125-2.125%	Interest Income Only	

[1]Residents pay 1.25% to the city and 0.75% for schools; nonresidents pay city tax only.

[2]Payrolls of less than $2,500 per quarter and all public employees are exempt.

[3]Taxpayers may credit taxes paid on their city of employment against taxes due to their city of residence in all Ohio cities.

[4]Nonresident rate is 4.31%.

[5]City tax is 2.125%, and school district tax is 1.857%. Nonresident rate is 1%.

Source: Commerce Clearing House, *State Tax Reporter*, various issues.

Table 2
LOCAL GOVERNMENT REVENUES, 1950-86
(in millions of dollars)

Year	General Revenue From Own Resources	Tax Revenue	Income Tax[1] Amounts	Income Tax[1] As Percent Of Local Revenue
1950	$9,586	$7,984	$64	.8
1955	14,737	11,886	143	1.2
1960[2]	22,912	18,081	254	1.4
1965	32,362	25,116	433	1.7
1970	51,392	38,833	1,630	4.2
1971	57,491	43,434	1,747	4.5
1972	64,449	48,930	2,241	4.6
1973	70,489	53,032	2,406	4.5
1974	76,742	56,515	2,413	4.3
1975	84,357	61,310	2,635	4.3
1976	93,186	67,557	3,127	4.6
1977	102,031	74,794	3,752	5.0
1978	110,730	80,381	4,071	5.1
1979	117,209	80,606	4,309	5.3
1980	130,027	86,387	4,990	5.8
1981	145,736	94,776	5,531	5.8
1982	163,240	103,641	6,105	5.9
1983	179,143	113,145	6,445	5.7
1984	196,504	123,399	7,215	5.8
1985	216,103	134,473	7,974	5.9
1986	233,406	144,997	8,536	5.9

[1]Census data for local income taxes do not include payroll taxes in California, New Jersey, and Oregon. They include local corporate income taxes. Beginning with 1982, separate data on local corporate income taxes are available: 1982—$1,027 million; 1983—$1,105 million; 1984—$1,535 million; 1985—$1,521 million; 1986—$1,588 million.
[2]Alaska and Hawaii included for first time.

Source: U.S. Bureau of the Census, *Governmental Finances*, various years.

of total local government tax revenues (see Table 2). There has been a slight increase during the 1980s in the number of jurisdictions using the local income tax from approximately 3,200 in 1979 to 3,550 in 1987,[11] but most of the total revenue growth has come from rising income and/or rising rates where the tax was already in use. The local income tax's relative share of total local revenue has remained modest and essentially unchanged during the last seven years.

In 1985, in the three states where they were most intensively used by local governments, these taxes accounted for as much as 13.6 percent of all local general revenues (taxes plus federal and state aid and user charges) (see Table 3). For some cities, it is a significant source of revenue. Philadelphia, for example, derives almost half of its own-source general revenue from this tax. (See Table 4 for some representative revenue figures for large cities.)

Table 3
LOCAL INCOME TAXES AS A PERCENTAGE OF LOCAL REVENUES, SELECTED STATES, FISCAL YEAR 1986

	Local Income Tax As a Percent of		
	All Local Revenues	Own-Source Revenues*	Tax Revenues
Maryland	13.6	20.7	28.9
Ohio	8.9	14.8	22.3
Pennsylvania	9.2	14.6	22.5

*Local general revenue exclusive of federal and state aid.

Source: Computed from *Significant Features of Fiscal Federalism, 1988 Edition*, Volume II (M-155 II), Table 65, p. 70.

Rates

In jurisdictions employing a single flat rate on payroll or wages, the rates range from 0.25 percent in several school districts in Ohio to 4.96 percent in Philadelphia. The most commonly used rate is 1 percent. Higher rates are found in Pittsburgh (4%, of which 2.125% is for the city and 1.875% is for the school district), Detroit (3%), Scranton, Pennsylvania (2.2%), large cities in Ohio (2% and 2.25%), San Francisco (1.5%), and Wilmington, Delaware (1.25%). In most cases, residents and nonresidents pay the same rate. In Michigan, however, nonresidents pay half the residents' rate. In Ohio school districts, nonresidents are exempt, and in some Pennsylvania cities, they pay a lower rate than residents.

States using the state or federal income base vary in their approach to rate setting and to taxation of nonresidents. In Maryland, residents pay 20% to 50% (usually 50%) of their state tax liability; nonresidents are exempt. Given the state rates, for those 19 (out of the total of 24) jurisdictions employing the 50 percent local rate, the effective rate is 2.5% of adjusted gross income in excess of $3,000. In Iowa, residents pay only a school district tax of up to 10% of their state tax liability. In Indiana, the tax is 1% of county adjusted gross income (0.25% for nonresidents).

Table 4
CITY REVENUES FROM LOCAL INCOME TAXES, 1984-85

	Total Revenue (millions)	Percent of Own-Source Revenue
All Cities*	**$6,627.0**	**4.4%**
Cities with Population:		
Greater than 1 million	$4,151.0	20.3
500,000-999,999	924.0	9.7
100,000-499,999	753.0	4.3
Less than 100,000	799.0	2.5
Selected Large Cities:		
Akron, OH	53.2	46.1
Baltimore, MD	92.0	14.3
Birmingham, AL	27.0	15.9
Canton, OH	22.4	56.7
Cincinnati, OH	112.1	44.9
Cleveland, OH	160.3	54.6
Columbus, OH	146.8	53.0
Dayton, OH	66.9	51.8
Detroit, MI	246.1	34.6
Flint, MI	22.2	12.6
Grand Rapids, MI	19.3	24.4
Kansas City, MO	74.0	19.6
Lexington, KY	44.3	40.1
Louisville, KY	51.1	36.1
New York City	3,159.6	23.0
Philadelphia, PA	745.4	49.2
Pittsburgh, PA	54.7	23.6
San Francisco, CA	82.9	4.4*
St. Louis, MO	78.0	21.8
Toledo, OH	87.5	51.6
Wilmington, DL	17.3	25.9
Yonkers, NY	19.2	10.9

*Does not include San Francisco and Los Angeles, CA, or Newark, NJ. Data for San Francisco from Carolyn Sherwood-Call, "The Labor Tax as an Alternative Revenue Source," *Proceedings of the Seventy-Ninth Annual Conference*, National Tax Association, 1986, p. 88.

Source: U.S. Department of Commerce, Bureau of the Census, *City Government Finances in 1984-85*, U.S. Government Printing Office, Washington, DC, 1986.

In New York, local income taxes are used only in New York City and Yonkers. In Yonkers, the tax is 15% of state tax liability (0.5% on earned income for nonresidents). New York City has progressive rates ranging from 1.5% to 3.5% of income for residents, and a single rate of 0.45% for nonresidents.

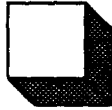
Revenues

In fiscal year 1986, local income taxes generated $8.5 billion in revenues. National figures on the relative importance of local income taxes are deceptively low because of the limited number of jurisdictions using them. In Ohio, Pennsylvania, and Maryland, the three states where the local income tax is most widely used, it is a sizable local revenue source (see Table 3).

For large cities, this tax can be of particular importance. Table 4 summarizes the revenues from the local income or payroll tax for 22 cities that employ the tax fairly heavily. The data indicate that five cities derived more than 50 percent of their own-source revenues from local income taxes in 1985, while seven other cities obtained more than 25 percent. In 1985, this tax provided almost half of its own-source revenues for Philadelphia, more than 50 percent for five Ohio cities, 23 percent for New York City, 22 percent for St. Louis, and 20 percent for Kansas City. In San Francisco, increases in the payroll tax rate from 1.1 percent to 1.5 percent in 1980 helped to blunt the impact of Proposition 13 on the city's revenues.[12] Thus, although not as widely used as the property tax, local sales tax, or fees and charges, the local income or payroll tax clearly plays a significant role in certain states and cities, especially large cities.

Geographic Distribution

The use of the local income tax is concentrated largely in the mid-Atlantic region and the Midwest (see Figure 1), with Pennsylvania, Ohio, and Maryland making the most intense use of this tax. Use of the tax is scattered across the rest of the country with no particular pattern, except that it is not used at all in New England or the Southwest, and very little in the Southeast and the West. In six states—Alabama, Arkansas, California, Missouri, Ohio, and New York—local governments may impose both local income (or payroll) taxes and local sales taxes. However, no cities in Georgia or Arkansas use the local income tax, and it is limited to only six cities combined in California, Missouri, and New York. In Ohio, the income tax is limited to municipalities, the sales tax to counties. Thus, there is very little overlap of a local income tax with a local sales tax.



Design Issues and Safeguards

In its 1974 report *Local Revenue Diversification: Income, Sales Taxes and User Charges*, ACIR cautiously supported the use of local income and sales taxes to achieve greater balance in local revenue sources:

> 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 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 [take the necessary safeguards]:
>
> *Safeguard: Uniform Tax Base*
>
> > Provide a uniform local tax base which should conform to that of the state if the state imposes the levy.
>
> *Safeguard: 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: 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: Constrained Rate Option

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

Safeguard: 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 nonproperty tax revenues among constituents 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: Income Tax Sharing

Specify arrangements for sharing taxes on earned income by nonresidents between tax levying jurisdictions of residence and employment.[13]

The recommended safeguards call attention to several important design issues in a local income tax, of which we shall examine four. The first issue is the base; specifically, whether to tax only payroll or wages or to use the broader base of the state income tax. With a payroll tax, the state must also decide whether the base should include residents only or extend to nonresidents employed in the taxing jurisdiction. The second issue is whether the state or local government should be responsible for administration. The third issue is whether the tax should be employed by all local governments of a particular type (e.g., school district, city, county) or on a local option basis. The fourth issue is whether the state should specify a single rate or a range of local rates.

Earned Income or All Income?

In 9 of the 14 states where local governments presently levy an income tax, the tax base is wages and salaries only. (In addition, all but

one city in Michigan use this type of tax.) Typically, there is a low flat rate; the most widely employed rate is 1 percent. This tax base usually excludes interest, dividend and rental income, self-employment income, retirement income, and any other forms of income not easily taxed by payroll withholding. Payments are usually received from persons who work in the city even if they reside outside the city. (However, in several states, nonresidents pay a lower rate. Taxation of nonresidents is addressed below in the evaluation section.) Clearly this choice of a flat rate with withholding as the collection method represents a vote for administrative simplicity and local control at the expense of greater equity.[14]

The major alternative is to make state taxable income or federal adjusted gross income the base for the local income tax and to link collection to state income tax collections. This "piggyback" option broadens the base to include all income and shifts the burden of collection to the state. From the local perspective, this option is likely to change the composition of the taxpaying group. A payroll or wage tax is usually collected at the workplace. Those who work in the city but reside outside will pay the tax, but any "reverse commuters" who live in the city but work outside it can escape the tax. With the piggyback type of tax, city residents also constitute city income taxpayers. In most states with a piggyback local income tax, some effort is made to capture income tax revenues from those who commute into the taxing city or county. Typically, nonresidents who work in the taxing jurisdiction are liable for the tax, but at a lower rate (see Table 1). The piggyback type of income tax, in comparison to a wage or payroll tax, involves some loss of local control and simplicity, offset by a gain in equity.

State or Local Collection?

For those local governments that use a surcharge on the state income tax, there are clearly significant savings in both administrative costs to the local government and compliance costs to the taxpayer if the program is administered by the state with a single tax form. However, one issue that may arise is how quickly the funds collected by the state are remitted to the local government for investment or expenditure. Having the state serve as the collection agent does not significantly compromise local control over whether to impose the tax and at what rate, although it may reduce taxpayer awareness of how much local as opposed to state tax is being paid. Nevertheless, except for Maryland (where state collection is mandated by law), New York, Iowa, and Oregon transit districts, most local income taxes are administered locally.[15]

The local payroll or wage tax lends itself more easily to local administration than the surcharge on the state income tax. The Pennsylvania payroll tax is entirely locally administered. Some jurisdictions share a collection agency; in Ohio, agencies in three large cities serve the local income tax collection needs of surrounding local governments.[16]

Universal or Local Option?

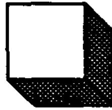
A tax that is used by all local jurisdictions of a specified type in a state—city, county, or school districts—at a uniform rate is really a tax shared by state and local governments rather than a genuinely local tax. Although the local sales tax is designed as a state-shared tax in several states, no states have opted to design the local income tax on the same model as that of the state-shared sales tax. In fact, only Maryland requires that the income tax be levied by all local governments of a particular type (counties). Thus, where local income and payroll taxes are used, even though the state imposes some elements of uniformity, it is still a truly local option tax—both in the decision to use it and often in the rate to be levied as well.

An important aspect of local option is whether voter approval is required. Four states (Arkansas, Georgia, Iowa, and Missouri) require local voter approval to levy the tax; Ohio requires voter approval for school districts but not municipalities, unless they wish to use a rate greater than 1 percent. The requirement of voter approval, except in Missouri, is a feature of the local income tax statutes enacted more recently by state legislatures. The tax is much less likely to be used in states that require prior approval from voters. In Georgia, its use has been inhibited not only by the prior approval requirement, but also because the authorizing legislation requires local governments to give up the established local sales tax if they opt to adopt an income tax.

The advantage of a universal local tax at a uniform rate within the state is that there will be less distortion of local decisions based on different tax situations. The drawback of a universal local tax is that the tax is not adaptable to local needs and preferences and is not under the control of local officials. Such a tax would be closer to state revenue sharing than to a truly local tax.

Rate Uniformity or Rate Diversity?

Another way in which local autonomy can be preserved is by leaving the decision on tax rates to local authorities. In the ACIR recommended safeguards, the Commission sought to balance the desire to preserve local autonomy with a need to limit tax differentials among jurisdictions within a state. Their solution was to suggest that local authorities be given a choice of tax rates within a specified range. ACIR observed that local autonomy could be preserved, even enhanced, as long as rate variations were not extreme. As Table 1 indicates, local rates are typically quite low. Most states specify either a single rate or a narrow range of rates.



Rationales

The rationales for raising revenue by taxing income rather than, or in addition to, sales or property, or imposing fees and charges is well documented in economics literature. There are two theoretical rationales—benefit and ability to pay—and two pragmatic justifications—revenue diversification and property tax relief.

The Benefit Principle

One principle of taxation is the benefit principle, first enunciated by Adam Smith: the taxes that one pays should be proportional to the benefits enjoyed by the taxpayer. Traditionally, the gasoline tax, earmarked for maintaining existing highways and building new ones, is the clearest example of a benefit principle tax in the United States. Property taxes are often justified on the benefit principle because many local services—fire, police, sanitation, street maintenance—can be regarded as services to property. The value of these services to the taxpayer is roughly proportional to the value of property owned.[17] However, given that a large share of local property tax revenues has been directed to public education in recent times, the argument for property taxes on the basis of the benefit principle is weakened.

The income tax is rarely considered a benefit principle tax, except in the very tenuous sense that the benefit provided may be the general umbrella of state protection of income earning opportunities. Given that a city provides income opportunities to both residents and nonresidents, a local income tax fits under the umbrella of Smith's justification for taxation. To the extent that public services make income earning possible or enhance the earning capacity of local citizens or complement the private uses of income, there is an element of benefit principle even in the income tax.

In fact, a case can be (and has been) made that the benefit principle justifies levying income and payroll taxes on nonresidents who work in a

local jurisdiction. It is argued that these persons use the services of local government. They park in the parking lots, walk the streets, generate trash, consume the city's cultural services, such as museums, and benefit from fire and police protection. If the only source of local revenue is the property tax, many nonresidents will pay no direct taxes to the local government where they work. Only those nonresidents who own or rent business property will pay direct taxes to that local government. (This same argument is used for justifying local sales taxes in a slightly different form.)

Thus, one way to charge for the services that these people enjoy is to levy an income or payroll tax on nonresidents, which then serves as a benefit principle tax. Recognizing that these people do pay property taxes where they reside, and that more local services—especially education—accrue to residents than nonresidents, some cities and counties tax nonresidents at a lower rate (see Table 1).

ACIR's earlier study weighed the advantages and disadvantages of taxing nonresidents:

> 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 nonconstituents and this may ease their task of "selling" a local income tax. Nonresidents voice the "taxation without representation" theme and further support their claims that their purchase 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.
>
> * * * * * * *
>
> Judging by actual experience, those local governments that are permitted to tax nonresidents 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.[18]

Frederick D. Stocker, looking for ways to relieve pressures on central city finances in the 1970s, pointed out that taxation of nonresidents was an even more explicit advantage of the municipal income tax:

> One of the most significant features of a municipal income tax is its ability to suck revenues out of the suburbs and into the central city, especially where the income tax applies to the income of residents and nonresidents alike.[19]

Do residents of the suburbs exploit the cultural amenities and other services provided by the central city? David Bradford and Wallace Oates argue that there is little evidence to support this contention. They found

that local taxes go overwhelmingly to support services to residents and particularly to schools, where the benefit is tied to the place of residence rather than to employment.[20] David King, however, in a survey of federal systems in several countries, concludes that capturing externalties generated by the city is an important issue in tailoring local public services to taxpayer requirements.[21] We will consider this issue later in this report in a broader context of evaluating the local income tax.

Ability to Pay

A second rationale for a particular tax is that it should be based on ability to pay. The income tax is usually given high marks on this criterion because income is the ultimate source of all tax revenues and, therefore, the best measure of ability to pay.

The relationship between local income taxes and ability to pay varies with the three basic types—earned income/payroll, piggyback (percentage of federal or state tax or taxable income), and the unique New York City progressive tax. ACIR's 1974 study was critical of the third type and, by implication, some taxes of the second type:

> 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.[22]

Whether a local income tax is an appropriate mechanism for raising revenue from an ability to pay perspective is, of course, a matter to be decided by local voters and elected officials. If such a tax is to be enacted, however, a strong case can be made on equity grounds for adopting a form of tax that at least shields subsistence income. A flat-rate local income tax, which has no exemptions or deductions, tends to offset the progressive and redistributive elements that may exist in federal and state income taxes, and to contravene the ability-to-pay principle.

The ability of most local tax systems to play a significant role in income redistribution is limited. Most local taxes, namely, property taxes and sales taxes and many user fees and charges, tend to be regressive, although there is an ongoing debate as to whether property taxes are actually regressive. A local income tax that is proportional or mildly progressive might offset to some extent whatever regressivity may exist in the rest of the local tax system.

In addition, taxpayer avoidance presents a problem for local income and payroll taxes. Even the flat-rate payroll tax generates some taxpayer avoidance. There are avoidance problems for a local income tax even when the tax is not progressive; and presumably they become worse with

a progressive income tax. Limited evidence from San Francisco and Philadelphia suggests that avoidance of local income and payroll taxes does occur, taking the specific form of the taxpayer locating outside the taxing jurisdiction to avoid the tax or at least reduce the tax burden.[23]

Some public finance theorists are critical of the use of any local taxes that are based on ability to pay, as opposed to user fees and benefit taxes, because of undesirable migration effects. A study by Timothy J. Goodspeed, however, finds that migration effects of ability-to-pay taxes imposed by local governments are likely to be very small.[24]

Diversification of the Tax Structure

A third rationale for adopting the income tax is based on its use as a complement to, rather than a substitute for, other local revenue sources, such as property taxes, sales taxes, and fees and charges. The diversification argument has received considerable attention as a way to make the tax structure more equitable and more efficient. A diversified tax structure captures revenues from those who can avoid some taxes but not others, and from those for whom a particular tax poses only a small burden. The property tax is a wealth tax, but not all wealth generates income with which to pay the tax, and not all forms of wealth are subject to the property tax. An income tax can thus generate revenue from those whose income substantially exceeds their local property wealth, while reducing the burden for those with tangible property wealth but low income.

A diversified tax structure can also help to keep all rates lower, and thus reduce the amount of distortion from high rates on a particular tax, such as the property tax. High property tax rates can discourage property improvements, encourage flight to the suburbs, and shift wealth into nontaxable forms. All other things being equal, high income taxes can discourage the substitution of labor for capital, encourage individuals and firms to locate in untaxed or low-taxed areas, and discourage work effort. High sales taxes can discourage consumption and encourage the flight of commercial facilities to other jurisdictions. To the extent that local taxes affect consumption and production decisions and locational choices, lower rates cause fewer such distortions of economic decisions.

Finally, it has been suggested that a diversified tax base offers a state or local government the same advantages that a diversified portfolio of financial assets offers individual investors. Any particular tax has certain strengths and weaknesses in terms of stability, growth, sensitivity to inflation, and the like. A diversified revenue base can offer a better mix of such attributes than dependence on a single tax.[25]

The diversification argument must be applied with caution to localities, however. The ability of a local government to implement a particular type of tax, such as an income or payroll tax, depends critically on its relationship to its surroundings. If the tax is used in adjacent jurisdictions, then there is less likelihood that the local tax will seriously affect locational and other economic decisions. If the tax is unique to the particular

jurisdiction (e.g., the payroll tax in Los Angeles and San Francisco), then the local government must weigh the revenue gains against the possible long-term losses in residents, business firms, and economic activity to the suburbs or other cities that do not levy an income tax.

This potential long-run risk in a local income tax is magnified with higher rates. A case in point is the Philadelphia income tax, one of the highest in the nation at 4.96 percent. This tax has been the main source of increased real tax revenues in Philadelphia during the last 20 years, largely as a result of rate increases. An econometric analysis by Robert Inman and colleagues indicates that the number of jobs lost as a result of the Philadelphia local income tax may be as high as 100,000 over the past 20 years.[26] A proposal was submitted in the 1988 Pennsylvania legislative session to reduce the rate from 4.96 percent to 4.3 percent (3.6 percent for commuters).

As the discussion above clearly shows, part of the case for adoption of a local income tax in any particular local jurisdiction depends on the specific characteristics of the jurisdiction and its revenue system, and also on the type of local income tax being considered. Whether the locality is the only jurisdiction in a region to employ the tax, or whether many other localities in the region also levy an income tax are significant factors in determining its impact on the local economy.

Property Tax Relief

A fourth rationale for using local income and payroll taxes is that they can relieve the burden on the property tax, either by lowering it or not increasing it. This rationale is closely related to the tax diversification argument. However, rather than being a general argument in support of tax diversification, it is directed to the role that local income and payroll taxes can play in helping communities alleviate what many observers see as a heavy reliance on property taxation that leads to high property tax rates, and frequently to taxpayer rebellions like Proposition 13 in California. Proponents argue that adoption of a local income tax can help stabilize the pressure on local property tax levels. Moreover, the authorization of local income taxes provides state legislators with a creditable argument for turning down city and county requests for other forms of "property tax relief," particularly local demands for a state revenue sharing program. However, some critics of the local income tax are concerned that it may be too productive as a revenue source, encouraging the growth of the public sector.

Elizabeth Deran, in a 1968 study of city tax structures, found that cities with income taxes generally exhibited lower property tax rates than cities of comparable size without income taxes.[27] In Indiana, authorization for the local income tax was an intentional part of a general property tax relief program. Starting in 1973,

> counties which chose to levy a local income tax had to freeze their property tax levy; counties which did not levy an income tax

had to freeze their property tax rate . . . . In addition, the state increased aid to local governments . . . . As a result of this program, farm property taxes actually decreased between 1971 and 1977, while residential property taxes increased slowly.[28]

Unfortunately, there are no recent statistical studies that conclusively support or dispute the role of local nonproperty taxes, such as sales and income taxes, as a form of property tax relief; however, the view that such relief is a major function of other local taxes is widely held among both public finance theorists and practitioners. James Rodgers listed both obtaining more revenue without higher property taxes and reducing property tax burdens among overlapping jurisdictions as being among the five major goals of local nonproperty taxes.[29] Arnold Raphaelson notes that

> . . . there has been a growing hostility to local property taxation in recent years . . . . [A]s local governments turned to other revenue sources, the percentage of total revenues collected as property taxes decreased.[30]

Aronson and Hilley, likewise, see local sales and income taxes as a form of property tax relief:

> The great surge in the use of local sales and income taxes occurred in the 1970s, with their relative importance increasing into the 1980s . . . . The availability of these nonproperty taxes has allowed local governments to diversify their revenue sources. Property tax revenues, which accounted for about 87 percent of local tax collections in 1960, accounted for only 75 percent in 1984.[31]

In a recent study of tax and expenditure limitations, Merriman observes the link between the property tax limitation movement and the use of other local revenue sources:

> . . . the idea that local governments can be induced to use new or different revenue sources through the imposition of a TEL [tax or expenditure limitation] has long been an element in the debate about the wisdom of such measures . . . . [S]ome of the earliest TELs were justified by the argument that they would encourage 'reform' of the property tax . . . later TELs, such as the 1970 state of Kansas measure . . . were sometimes explicitly designed to encourage the use of nonproperty tax revenues.[32]

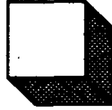
Merriman also cites a statistical study by Inman, who observed that large cities, given the opportunity, will choose to diversify their tax portfolios, and that offering cities other choices (he mentions local selective and general sales taxes) generated measurable reductions in the share of the property tax in total revenues.[33]

Finally, a group of practitioners/legislators in South Carolina summarized a 1979 review of alternative local revenue sources (including local income and sales taxes) with the following comments:

> . . . overwhelming dependence on the property tax presents many serious problems . . . the property tax does not provide governments with the kind of broad-based, *balanced* revenue system that they must have if they are to function as autonomous governmental entities . . . . Any new tax instruments provided to local governments should be provided as means to make reductions in some existing taxes, most prominently the property tax.[34]

The report went on to recommend the local accommodations tax, the local income tax, and the local sales tax as additional revenue sources. While only one of the proposed alternative local revenue sources (the accommodations tax) was implemented in the short term in South Carolina, a bill introduced in 1987 offered six new local (tax) revenue options and was called the Local Government Finance Act. It met considerable opposition. In 1988, in an attempt to package the idea in a form more palatable to the public, the bill was reintroduced, the number of local tax options was reduced, the use of such taxes was tied to property tax rollbacks, and the bill was retitled the Property Tax Relief Act. Clearly, many see a close need to link the use of local nonproperty taxes with property tax relief.

Although proponents of enacting a local income tax frequently link it to property relief, such "relief" rarely means a reduction in individual property tax bills. The use of a local income tax for property tax relief may prevent further increases in property tax bills, or moderate the rate of future increases. While imposition of a local income tax may reduce the proportion of total local revenues raised from property taxes, it may or may not reduce the total local tax burden.



Evaluation

In its original (1961) study of local nonproperty tax revenues, ACIR expressed reservations about the use of local income taxes, primarily because they tap a revenue base already employed by the federal government and many states:

> The mushrooming of miscellaneous kinds of local taxes across the country poses problems of public policy . . . . Local sales, income and tax practices add still another layer to existing tax overlapping.[35]

Among the concerns expressed in that report were distortions of economic choices, high administrative and compliance costs, and limitations on the freedom of the state to expand reliance on income (and sales) taxes. By 1974, however, experience with local income taxes had led to a more positive review in the second ACIR study, which concluded that:

> Local income taxes, like local sales taxes, are one device by which local governments can diversify their revenue structures. As a broad-base 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.[36]

Many economists favor use of the income tax by the states and the national government. A progressive income tax usually receives high marks for equity, for minimum distortion of economic decisions, for low administrative costs, and for sensitivity to economic growth. However, economists are more inclined to question its use as a local revenue source because of concerns about tax competition, locational effects, and administrative problems. Like ACIR in the 1961 study, some observers

were initially concerned about overlap and coordination as this tax began to spread.[37] In a federal system, the heavy reliance of one type of government on a particular tax generally limits its use by other governments. Both the individual income tax and the Social Security payroll tax are major revenue sources for the federal government, together accounting for about two-thirds of federal revenues in 1986. Because of federal reliance on this revenue source, states generally deferred adopting income taxes in favor of sales taxes, where they had a clear field. Local governments likewise were slow to move into a field already used by the state and national governments.

Nevertheless, the income or payroll tax does offer some attractive features for local governments. In what follows we will evaluate the local income tax on the traditional criteria used to rate revenue sources, paying particular attention to the local aspects of these criteria and placing the evaluation in the context of the types of local income taxes currently in use.

Yield

The yield of any tax depends on the breadth and depth of its base, the opportunities for evasion and avoidance, and the rates levied. Both the payroll tax and the income tax have broad bases. Wages are a large component of income for most people, and the payroll tax allows no deductions or exemptions in most cases. The base for other local income taxes is determined by the base of the state or federal income tax, except for New York City.

The payroll tax is extremely difficult to evade or avoid. Escaping the local income tax depends partly on locational choice and partly on local efforts to ensure compliance. To the extent that individuals can reduce their federal or state income tax liability through deductions, exclusions, or other methods, they can also reduce their local income tax liability (not payroll tax liability) when the local income tax is linked to the state or federal income tax.

Most local income tax rates are low, in the 1 percent to 3 percent range. In comparison, the average effective property tax rate in the U.S. is about 1.2 percent. Given that the property tax is a tax on wealth, the appropriate comparison is between the income tax rate as a percentage of the income base and the property tax as a percentage of the income that the taxed property yields. Assuming that the income yield on assets subject to property taxes is about 10 percent, the property tax rate computed as a percentage of income stream rather than the value of the asset would be 12 percent or a considerably higher rate than the typical local income tax rate.

Elasticity and Stability

Elasticity measures the responsiveness of tax revenue yield to changes in the size of its underlying base. For example, an elasticity of 1.0 indi-

cates that the tax yield will increase by the same percentage as the percentage increase in the income or payroll base. A tax elasticity of more than 1.0 produces an increase in yield greater than the increase in the base: for example, an elasticity of 1.4 means that each 10 percent increase in the tax base produces a 14 percent increase in revenue. An elasticity of less than 1.0 means that yields are increased proportionately less than the increase in the base as the base grows.

Economists have devoted considerable time and effort to estimating the elasticities of various taxes. A recent summary of these studies by the U.S. Department of the Treasury indicates that although there is considerable variation in the estimates of the elasticities of the different taxes, there is general agreement on the relative rankings of the elasticity of different taxes. Table 5 shows the range of elasticity estimates. Note that these are national estimates, not estimates for individual states.

Estimates of state personal income tax elasticities on a national basis range from 1.13 to 2.08. (One estimate of the state income tax elasticity for Arkansas cited in the Treasury study is 2.40). An average income tax elasticity estimate is 1.6. The Department of the Treasury uses a conservative state income tax elasticity figure of 1.4 in its economic analyses.[38] An elasticity of 1.4 -1.6 means that every 10% increase in income would generate a 14 to 16 percent increase in income tax revenue.[39]

For piggyback local income taxes, such as that used in Maryland, the elasticity will depend on the elasticity of the underlying state tax. The elasticity of a local wage or payroll tax is lower than that of the more comprehensive income taxes, but it is also a more stable revenue source because there are greater fluctuations in earnings from the interest, dividends, rent, and capital gains included in an income tax. One study of

Table 5

ESTIMATES OF THE INCOME ELASTICITIES OF THE MAJOR STATE-LOCAL TAXES, ALL STATES, VARIOUS YEARS, 1965-86

Tax	Range of Estimates of Elasticity	
	Economists	Treasury
Personal Income Tax	2.08–1.13	1.4
General Sales Tax	1.37–.59	1.1
Corporate Income Tax	1.34–.73	N.A.
General Property Tax	1.30–.80	N.A.
Taxes, Other Than Income and Sales (including property)	N.A.	.9

Source: A summary of figures for the United States (not individual states) from Robert A. Aten, "Technical Notes on the State-Local Model," in U.S. Treasury, *Federal-State-Local Fiscal Relations*, Technical Papers, Volume II, 1986, Table 1, pp. 576-7.

the revenue fluctuations in four major cities (three of which used payroll-type local income taxes) found that the revenues from this source were highly stable despite ups and downs in the local economy.[40]

Many elected policymakers view as highly desirable a tax whose yield automatically grows at a faster clip than that of the economy. Revenues increase with population and economic activity, financing the additional public services that may be required. However, from the standpoint of the taxpayer, high income elasticity for a tax may mean siphoning off additional revenues to local government automatically rather than subjecting this process to legislative or public approval processes. Those who wish to contain the growth of government would prefer to use a less elastic tax base, or, at least, a flat tax rate.

Elasticity has a downside, too; revenues may drop off sharply in a recession, forcing curtailment of public services. The federal government is able to borrow during recessions, and some state governments have rainy day funds or other resources that will tide them over for a short period, but local governments have less flexibility in coping with a sudden and unexpected decline in revenues.

Administrative/Compliance Costs

The 1974 ACIR study strongly recommended state administration of local income taxes. Although there is very little information on the costs of collecting local income taxes, John W. Lynch estimates the collection cost of a state income tax to be 1.58 percent of revenue collected at a rate of 4 percent, dropping to 1.20 percent at a 5 percent tax rate.[41] State administration of local income taxes can reduce costs, although the savings to the local government in personnel and administrative costs must be weighed against the charges assessed by the state and the costs of delays in receiving the funds collected. Even large cities rely on state administration; New York City's local income tax is administered by the state.

With local administration, taxing earned income only and relying on withholding rather than filed returns by individual taxpayers considerably reduces the complexity and the number of returns, thus lowering administrative and taxpayer compliance costs. Both costs still remain high under the wage or payroll tax for most proprietorships or partnerships because, for these small firms, withholding is often not feasible.[42]

ACIR, in its 1974 study, noted that if progressivity is desired in the local income tax, it is administratively less costly to achieve that goal with exemptions rather than a progressive rate structure:

> 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.[43]

John Bowman and John Mikesell argue that administrative costs can be reduced while at the same time providing a tax that is more equitable and less likely to distort economic decisions if the tax has state-local base conformity, state administration, and wide area adoptions.[44] However, only Maryland has required state administration, although it is available as an option in other states, such as New York and Iowa.

Equity Aspects

ACIR's 1974 study gave a qualified endorsement to the income tax on equity grounds:

> 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 in 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. . . .[45]

In states that tie the local income tax to the state tax, the equity of the local tax is keyed to the equity of the state income tax. If the local income tax is levied at a flat rate on the same income base, it will still be mildly progressive as long as there are personal exemptions and standard deductions in the state income tax. If the local income tax is computed as a percentage of the state income tax liability, then it shares all the equity aspects as well as other advantages and defects of the state income tax.

In some cases, the local income tax is viewed as a way to reduce local dependence on state and federal aid to local governments, or state or federal assumption of responsibilities. With the end of General Revenue Sharing in 1986, increased attention has been given to strengthening the local revenue base. The advantages of locally raised revenues are better control and accountability. However, the local income tax does nothing substantial to improve the tax base of low-income jurisdictions and thus alleviate the need for state and federal grants, revenue sharing, or assumption of responsibilities for distributional reasons. According to James Rodgers:

> To redistribute income from high- to low-income jurisdictions, state or federal funding of local expenditures is more effective than any type of local taxation. Distributing state or federally collected revenues back to local government can then be based on a formula that favors poorer jurisdictions. In part, the controversy

over the extent to which local taxation should be used to fund local expenditures focuses on how much income redistribution among local governments is desirable, how much should be accomplished by giving income transfers to the poor directly, and how much should be provided by transfers of resources to the local governments in which the poor are more heavily concentrated.[46]

Tax Situs: Residents or Workers

The issue of taxing residents or taxing workers is a difficult one that is resolved differently in various states. Extreme lack of coordination of local income taxes between adjacent or overlapping jurisdictions can result in double taxation, but usually that is avoided within a state. In the absence of interstate compacts, however, it is possible for those who commute across state boundaries to experience double taxation.

Usually, basing local income taxation on place of residence favors suburban communities; the choice of workplace favors central cities. Tax credits may be used to balance the claims of two competing jurisdictions. In Pennsylvania, except for Pittsburgh and Philadelphia, residence has preference; in Ohio it is the place of employment. In several states, nonresidents pay a lower tax rate (see Table 1).

Probably no other single issue pertaining to local income taxes has caused as much controversy as the appropriate treatment of nonresidents. This question has important legal as well as economic ramifications, which vary from state to state.[47] Solutions to the problem of whom to tax vary. In Alabama and Kentucky, because the local income tax is set up technically as an occupational license tax, there is no possibility of double taxation. Maryland, Michigan, and Pennsylvania (except for Philadelphia and Pittsburgh) tax residents only. Iowa school districts tax only residents of the school district. Philadelphia, as the largest city in Pennsylvania, is given first claim on taxes from nonresidents, who may then credit their Philadelphia tax against any local tax in their city of residence. Ohio residents are allowed a credit in their city of residence for taxes paid to the city of employment, giving the employment city prior claim.[48]

ACIR's 1974 study recommended that the tax be shared between the places of residence and employment. Pennsylvania has adopted that procedure for overlapping jurisdictions. In most states, jurisdictional overlap is not a problem because, typically, only one type of local government (county, city, or school district) may use the tax.[49]

Locational Effects

The smaller the geographic division that employs the tax and the higher the rate, the more likely it is that the tax will influence taxpayers to locate their work or residence outside the city. Although central cities

have used the tax to capture revenues from commuters, it has probably contributed to some exodus from these cities.

For example, some of the peculiar features of San Francisco's payroll tax generate identifiable locational effects. Firms are excused from the tax if their tax liability would be less than $2,500 (an annual payroll of less than $166,667 at the current rate of 1.5%). In addition, banks, insurance companies, and regulated utilities are exempt by state law. The impact of this exemption is to encourage such firms to locate in downtown San Francisco, contributing to the growth of the banking industry there, but at least some observers note an exodus of labor-intensive firms to the suburbs.[50] Inman's study, cited earlier, also identified some locational impact of Philadelphia's very high local income tax.[51] According to this study, econometric analysis suggests that "perhaps as many as 100,000 jobs were lost over the past two decades."

If the tax is widely used at low rates, locational effects will probably be minimal, especially if the tax reduces the burden on the property tax and/or improves the attractiveness of the locality with better local public services. To date, with the exception of the studies mentioned above, little research has been done to demonstrate the existence or absence of significant locational effects.[52]

One of the purposes of a local income tax in many states is to strengthen the revenue bases of central cities. Capturing the earnings of commuters in the tax base must be weighed against any potential undesired locational effects. At least one study of Ohio cities found that an employment income tax base is stronger than a residence income tax base for central cities, while the reverse is true of many smaller communities.[53]

Relation to State and Federal Income Taxes

As noted earlier, there may be some degree of competition for the same tax base when an income tax is employed by all three levels of government. The fact that this tax is heavily used by the federal and state governments limits its usefulness for local governments, and particularly puts an upper limit on the rates they can set.

Recent changes in the federal income tax code may make local income taxes more attractive as a revenue source. The loss of sales tax deductibility might make the local income tax relatively more acceptable than local sales taxes to taxpayers who itemize; however, even before passage of the *Tax Reform Act of 1986*, less than half of the taxpayers itemized, and the proportion is expected to decline sharply. In addition, lower federal tax rates reduce the value of the deduction. The reduction in federal tax rates may allow some leeway for increased local income tax rates. In states and localities that use federal taxable income as the base for computing the tax, revenue should rise because the federal base has been broadened by the 1986 reforms.[54] The full impact of the 1986 federal income tax reform on state and local finances has yet to be observed,

and states and localities have not had much time to react to changes, but the new tax law appears to be at least slightly more hospitable to expanded use of local income taxes than before, primarily because of the loss of sales tax deductibility and lower federal rates.[55]

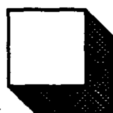
Public Receptivity

The 1987 ACIR annual public opinion survey included a question about the best way to collect additional local revenue.[56] The question was, "If your local government decided to raise a small amount of additional revenue to help meet costs and improve services, which one of these would you prefer?" The responses were as follows:

Charges for Specific Services	33%
Local Sales Taxes	20%
No Tax Increase/No New Taxes (volunteered)	17%
Local Income Taxes	9%
Local Property Taxes	9%
Don't Know/No Answer	12%

Clearly, the local income tax is not a popular alternative source of additional local revenue. Despite the loss of deductibility of sales taxes on federal income taxes, sales taxes remain considerably more acceptable than local income taxes, as do user charges and fees, which also are not deductible. The 1987 public opinion poll also found that increased state income taxes were far down the list of popularity as a source of added state revenue, and even a national sales tax levied by the federal government was preferred to a federal income tax increase.

On the same survey, the federal income tax had finally reversed its steady decline in the rankings on fairness (respondents were asked to select which is "the worst tax, that is, the least fair.") The property tax fared worse in the earliest poll in 1972 (45% versus 19% for the federal income tax), but after 1979 the federal income tax was ranked worst. In 1987, the federal income tax was ranked worst by 30% of respondents, while local property taxes came in second at 24%. (The federal income tax position in 1987 is an improvement from the 35-38% "worst" rankings from 1979 to 1986, perhaps as a result of the 1986 tax reform.) However, the income tax remains unpopular, and the acceptability of local income taxes is probably somewhat influenced by the continued unpopularity of the federal income tax.



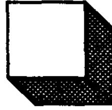
Summary and Conclusions

The local income tax has earned a modest place in the repertoire of local revenue sources. Even though its overall revenue significance is small, it is a major source of revenue in three states and a number of large cities. It has helped some local governments to diversify their revenue systems; made it possible for some jurisdictions to lessen their reliance on the local property tax; and provided some rapidly growing areas with a revenue source that is more capable than the property tax of keeping pace with growing expenditure demands. The local income tax appears to have some distorting effects on locational decisions where it is used only in a few jurisdictions in a region, or where the rate is high. It has enabled central cities to capture tax revenue from commuters, although it is arguable whether those revenues bear any meaningful relationship to the benefits commuters derive from central city services.

Although the pace of adoption of local income taxes has slowed (most local income tax revenue increases have come from economic growth or rate increases), developments on the federal fiscal scene may stimulate more localities to consider a local income tax. These developments include the end of the federal government's General Revenue Sharing program, a steady decline in federal aid (in constant dollars) to states and local governments, and the impact of the *Federal Tax Reform Act of 1986*, which lowered federal personal income tax rates and ended the deductibility of state and local sales taxes. The combined effect of these developments may cause state and local governments that had previously been reluctant to consider authorizing local income taxes to reconsider their adoption. However, as the ACIR poll suggests, a local income tax is not popular as a new source of revenue.

In states and localities considering its adoption, the issues that are consistently most difficult to resolve are the base (earned income or all income), the taxation of nonresidents, the appropriate rate, the types of

jurisdictions to be allowed to use the tax, and whether use of a local income tax should be linked to reductions in property taxes. Those states that have authorized localities to use this tax have resolved these questions in a variety of ways. With declining federal aid and changes in federal tax law, other local governments may be led to explore the local income or payroll tax as one of several potential revenue sources in the last decade of the century.



Notes

[1]Rodgers, James D., "Sales Taxes, Income Taxes, and Other Nonproperty Revenues, " in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Third Edition (Washington, DC: International City Management Association, 1987), p. 229.

[2]U.S. Advisory Commission on Intergovernmental Relations (ACIR), *Significant Features of Fiscal Federalism, 1988 Edition*, Volume I, M-155 (Washington, DC: ACIR, 1988), Tables 19 (local income taxes) and 20 (local payroll taxes).

[3]ACIR, *Significant Features of Fiscal Federalism, 1988 Edition*, Volumes I and II, M-155/M-155 II, Table 62.3.

[4]Ibid., (M-155 II) p. 54. Property taxes accounted for 74.0% of local tax collections; general and selective sales taxes, for 15.6%; local income taxes for 5.9%; and all other taxes for 4.5%. Local tax revenues refers only to revenues raised through local taxes, not by any other means. If all general revenue (which includes nontax sources) is examined (Ibid., p. 48), for FY 1986 local income taxes at 1.8% are below state aid, property taxes, all user charges, miscellaneous general revenue, federal aid, general sales taxes, and other taxes.

[5]For a description of key features of local income taxes, see ACIR, *Significant Features, 1988 Edition*, Volume I; and Rodgers, "Sales Taxes, Income Taxes, and Other Nonproperty Revenues," pp. 229-59. Current information on local income taxes is available in Commerce Clearing House, *State Tax Reporter* (Chicago: Commerce Clearing House, various years).

[6]For a description of the payroll taxes used in California and Oregon, see Carolyn Sherwood-Call, "The Labor Tax as an Alternative Revenue Source," *Proceedings of the Seventy-Ninth Annual Conference* (Columbus, OH: National Tax Association, 1986), pp. 86-93.

[7]Washington, DC, uses a similar tax, but for purposes of this study it is considered a state rather than a city.

[8]Rodgers, p. 258.

[9]Merriman, David, *The Control of Municipal Budgets: Toward the Effective Design of Tax and Expenditure Limitations*. (New York: Quorum Books, 1987), pp. 20-23.

[10]Rodgers, p. 244.

[11]*ACIR, Significant Features, 1988 Edition*, Volume I, Table 19, p. 46.

[12]Michael Wiseman, "Whatever Happened to the Proposition 13 Blues?" *Proceedings of the Seventy-Ninth Annual Conference* (Columbus, OH: National Tax Association, 1986), pp. 77-85.

[13]ACIR, *Local Revenue Diversification: Income, Sales Taxes & User Charges* (Washington, DC: ACIR, 1974), pp. 2-3.

[14]As Table 1 suggests, however, different earned income taxes treat nonresidents differently. Some offer lower rates for nonresidents; others, a credit for tax in one place against tax in another to avoid duplication.

[15]Rodgers, pp. 229-59.

[16]*Ibid.*, p. 246.

[17]There is some debate over whether the property tax is, in fact, a benefit tax. The well known Tiebout model suggests that individuals select communities in which to locate at least partially on the basis of the mix of services received and taxes paid. That model alone does not convert the property tax into a benefit tax, but it can be converted into a benefit tax when combined with zoning that narrows the range of property values, so that each household consumes approximately the same range of local services and pays approximately the same amount of tax. See Hamilton, "Zoning and Property Taxation in a System of Local Governments," *Urban Studies*, June 1975, pp. 205-11.

[18]ACIR, *Local Revenue Diversification*, p. 56.

[19]Frederick D. Stocker,"Diversification of the Local Revenue System: Income and Sales Taxes, User Charges, Federal Grants," *National Tax Journal*, September 1976, p. 315.

[20]David F. Bradford and Wallace E. Oates, "Suburban Exploitation of Central Cities and Government Structure," in Harold Hockman and George Peterson, eds., *Redistribution through Public Choice* (New York: Columbia University Press, 1974), pp. 43-48.

[21]David King, *Fiscal Tiers: The Economics of Multi-Level Government* (Winchester, MA: Allen and Unwin, 1984), Chapter 6.

[22]ACIR, *Local Revenue Diversification*, p. 56.

[23]Wiseman, pp. 77-85, and Robert P. Inman, et al., "Philadelphia's Fiscal Management of Economic Transition," in T.F. Luce and A.A. Summers, eds., *Local Fiscal Issues in the Philadelphia Metropolitan Area* (Philadelphia: University of Pennsylvania Press, 1987).

[24]Timothy J. Goodspeed, *A Reexamination of the Use of Ability to Pay Taxes by Local Governments*, unpublished working paper, U.S. Department of the Treasury, Office of Tax Analysis, Revised January 1988.

[25]For an evaluation of state and local taxes in a portfolio model, see Fred C. White, "Trade-Off in Growth and Stability in State Taxes," *National Tax Journal* 36 (March 1983): 103-14; and Walter S. Misiolek and D. Grady Perdue, "The Portfolio Approach to State and Local Tax Structures," *National Tax Journal* 40 (March 1987): 111-4.

[26]Inman, et al.

[27]Elizabeth Deran, "Tax Structure of Cities Using the Income Tax," *National Tax Journal* 21 (June 1968): 147-52.

[28]Steven D. Gold, *Property Tax Relief* (Lexington, MA: D.C. Heath Company, Lexington Books, 1979), p. 301.

[29]Rodgers, p. 229.

[30]Arnold Raphaelson, "The Property Tax," in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finances*, 3rd edition, p. 229.

[31]J. Richard Aronson and John L. Hilley, *Financing State and Local Governments*, 4th edition (Washington, DC: The Brookings Institution, 1986), pp. 142-3.

[32] Merriman, p. 70.

[33] Ibid., p. 71.

[34] South Carolina General Assembly, *A Balanced Revenue System for Local Governments in South Carolina: A Policy Statement*, Interim Report, Study Committee on Alternative Sources of Revenue for County and Municipal Governmets, February 1979, pp. 1,6.

[35] ACIR, *Local Nonproperty Taxes and the Coordinating Role of the State* (Washington, DC: ACIR, 1961), p. 5.

[36] ACIR, *Local Revenue Diversification*, p. 56.

[37] Stocker, pp. 312-21.

[38] See Robert H. Aten, "Technical Notes on the State-Local Model" in U.S. Department of the Treasury, *Federal-State-Local Fiscal Relations, Technical Papers, Volume II* (Washington, DC: Department of the Treasury), pp. 571-92.

[39] Catherine L. Spain and Blue Wooldridge, "Financing Local Government in the 1980s: Expansion through Diversification," in Norman Walzer and David Chicoine, eds., *Financing State and Local Governments in the 1980s* (Cambridge, MA: Oelgeschlager, Gunn, and Hain, 1981), p. 123.

[40] Rodgers, p. 250.

[41] John W. Lynch, "Local vs. State Administration of Local Option Nonproperty Taxes," *Proceedings of the Sixtieth Annual Conference* (Columbus, OH: National Tax Association, 1967), pp. 489-504.

[42] Rodgers, pp. 245-6.

[43] ACIR, *Local Revenue Diversification*, p. 56.

[44] John H. Bowman and John L. Mikesell, "Fiscal Disparities and Major Local Nonproperty Taxes: Evidence from Revenue Diversification in Indiana, Maryland, Ohio, and Virginia," *Proceedings of the Seventieth Annual Conference* (Columbus, OH: National Tax Association, 1977), p. 413.

[45] ACIR, *Local Revenue Diversification*, p. 56.

[46] Rodgers, p. 250.

[47] Davis and Ranson provided a comprehensive review of the legal history of this question in a 1969 study of municipal income taxation. See Joe Davis and Arthur Ranson, "Evaluation of Municipal Income Taxation," *Vanderbilt Law Review* 22 (1969): 1313-75.

[48] Rodgers, pp. 245-6.

[49] ACIR, *Local Revenue Diversification*, pp. 3-6, 55 ff.

[50] Wiseman, pp. 77-85.

[51] Inman, "Philadelphia's Fiscal Management of Economic Transition."

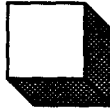
[52] Rodgers, pp. 245-6.

[53] John H. Bowman and John L. Mikesell, "Revenue Diversification within Metropolitan Areas: Effects on Disparities and Central City-Suburban Fiscal Relationships," *Review of Regional Studies*, Winter 1978, p. 68.

[54] ACIR, *The Tax Reform Act of 1986—Its Effect on Both Federal and State Personal Income Tax Liabilities* (Washington, DC: ACIR, 1988).

[55] The 1986 tax reform spawned a voluminous literature on the impact on state and local finances. For a recent summary discussion, see Roy Bahl, "Urban Government Finance and Federal Income Tax Reform," *National Tax Journal* 40 (March 1987): 1-18.

[56] ACIR, *Changing Public Attitudes on Government and Taxes—1987* (Washington, DC: ACIR, 1987).



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