

A STAFF REPORT

**Local Revenue
Diversification**

**Local
Sales Taxes**



**Advisory Commission on
Intergovernmental Relations**

SR-12
September 1989

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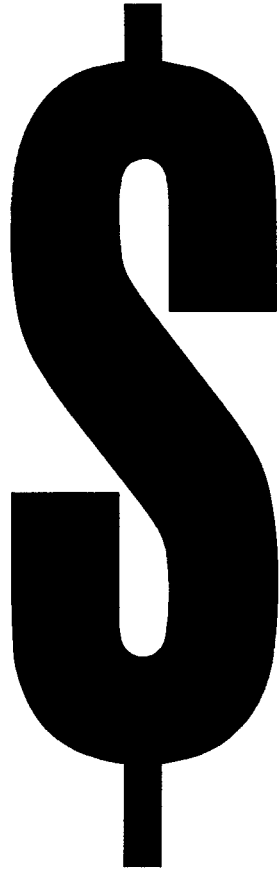
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A STAFF REPORT

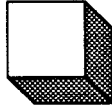
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Introductory Notes

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.

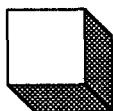
The lesson is clear; an efficient and equitable local revenue system should rely on a well-balanced and diversified set of taxes. In addition to avoiding the problems created by excessive reliance on any single tax, a balanced and diversified revenue system may create a more favorable business climate,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

Holley Ulbrich of Clemson University researched and drafted this report. Susannah Calkins (prior to her retirement) and Carol Cohen took major responsibility for the editing and final preparation of the report. Former ACIR Executive Director John Shannon was responsible for the initiation of this series of studies. Comments on the study were received from James Buresh, John Due, Harley Duncan, John Gambill, Steven Gold, and John Mikesell.

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

John Kincaid
Executive Director

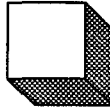
Robert D. Ebel
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Introduction

Local general sales taxes are levied by local governments on the value or volume of most types of goods and services sold in their jurisdictions.¹ They are the second largest source of local tax revenue in the United States, following the property tax.² In 1988, the local sales tax was used in 30 states, and accounted for more than 10 percent—and up to 26 percent—of local own-source revenues in 13 states. This tax is particularly important to cities, where, on average, it accounted for 10 percent of local own-source revenues and 17 percent of local tax collections in 1987.³

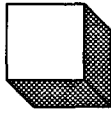
ACIR examined the role of nonproperty local taxes in the state-local tax structure in 1961 and again in 1974. The 1961 study cautiously supported limited use of nonproperty taxes, particularly income and sales taxes, and argued that such taxes should be state administered; conform to the state base; and have rates low to avoid high administrative costs, tax overlapping, and distortions of location decisions.⁴

By 1974, the Commission had shifted to a more positive view of local sales taxes, largely in response to local needs to raise revenue in the face of growing property tax resistance. Other factors cited for the change in stance were the steady growth in the use of the local sales tax, its responsiveness to growth and inflation, and the reluctance of states to assume an increased share of state-local fiscal responsibility. The 1974 report contained the following conclusion and recommendation:

The Commission concludes that our tradition of strong local governments argues in favor of a state policy that grants wide latitude to local elected officials in the selection of appropriate revenue instruments 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 income tax or a local sales 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.⁵

This report provides updated information on the local sales tax, including data on its continued growth and the results of recent research, but contains no new Commission recommendations. Publication of the report does not imply support for any particular local sales tax policy. The report describes the development and use of the local sales tax, discusses its rationales and effects, identifies design considerations, and concludes with a discussion of current issues concerning the local sales tax.



Development and Use of the Sales Tax

Historical Background

Like most state sales taxes, local sales taxes were first adopted in the 1930s, when the Depression put pressure on local governments to diversify their revenue sources. Land values and income from real property fell far more rapidly than did property taxes, and foreclosures to pay property taxes were increasingly common. Hostility toward the property tax, combined with pressing expenditure demands brought on by the Depression, forced local governments to look for alternative tools for raising revenue.⁶

The first local sales taxes were enacted in New York City in 1934 and New Orleans in 1936. California and Illinois authorized local use of the tax in the next decade, and Mississippi introduced the state-administered local sales tax in the 1950s. During the 1960s, there was a second wave of state adoptions, and there has been a slow but steady increase since that time. According to one count, in the seven-year period 1963-1970, the number of states authorizing local sales taxes grew from 12 to 25; by the late 1980s, 31 states authorized the tax and 28 had at least some local jurisdictions reporting revenue from sales taxes.⁷ Other states and local jurisdictions continue to explore such a tax as a form of local revenue diversification.

Table 1 (page 4) shows the growth in the number of jurisdictions using the local sales tax and the revenue significance of the tax. Between 1976 and 1988, the number of jurisdictions using the tax rose from 4,893 to 6,955, a 42 percent increase. Between 1966 and 1987, local sales tax revenues as a share of local revenues approximately doubled, from 3.8 percent to 6.7 percent of local own-source revenues and from 4.9 percent to 10.7 percent of total local tax revenues.

State Authorization of Local Sales Taxes

With few exceptions, local governments require authorization from the state to use a local sales tax, and a referendum is often required. Usually, the local sales tax is a close relative of the parent state sales tax. Alaska is the only state without a state general sales tax that authorizes a local general sales tax. Thirty-one states permit—or sometimes even require—the use of sales taxes by one or more types of local government. General licensing powers of local

Table 1
Use of Local Sales Taxes, Selected Years 1966-88

Year	Number of Local Jurisdictions Using Tax	Local Sales Tax Revenue (millions)	Revenue as a Percent of:	
			Local Own- Source Revenue	Local Tax Revenue
1966 ¹	n.a.	\$ 1,352	3.8%	4.9%
1976	\$4,893	4,594	5.0	6.9
1986	6,705	15,528	6.7	10.8
1987	6,889	16,756	6.7	10.7
1988	6,955	n.a.	n.a.	n.a.

n.a.—not available.

¹Includes the District of Columbia.

Sources: Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism, 1989 Edition, Volume I*, January 1989, Table 27, updated; and U.S. Department of Commerce, Bureau of the Census, *Government Finances in 1965-66, Government Finances in 1975-76, Government Finances in 1985-86, and Government Finances in 1986-87*.

governments in Alabama and Arizona are adequate to allow local governments to use sales taxes without specific state legislative authorization. Home rule powers given to cities in a few states also permit a local sales tax without specific state authorization.

Local sales taxes, like local income taxes, are most likely to be authorized for use by general purpose local governments, specifically municipalities and counties. States also authorize the use of general sales taxes by special districts, primarily transit districts: 158 special districts in eight states use the tax.⁸ Louisiana allows school districts to use general sales taxes.⁹

In most cases, states offer either the sales tax or the income tax as a local revenue option, but rarely both. Only five states (Alabama, Iowa, Missouri, New York, and Ohio) permit both local income or wage taxes and local sales taxes. Ohio authorizes cities to use the income tax, reserving the sales tax for counties. Iowa cities and counties may use the local sales tax, but only school districts use the local income tax. Only four cities (excluding the District of Columbia, which is considered a state for our purposes) levy both taxes: Birmingham, Alabama; Kansas City and St. Louis, Missouri; and New York City.¹⁰

Jurisdictions Using the Local Sales Tax

As shown in Table 1, approximately 7,000 local jurisdictions use the general sales tax,¹¹ roughly double the number with local income taxes (3,567 in 1988).¹² The number of sales tax jurisdictions has experienced more rapid growth in recent years. Generally, in states where both local income taxes and sales taxes are authorized, a much larger number of local jurisdictions has chosen to use the local sales tax.

In 1987, several types of general and special-purpose local governments used the local sales tax, 80 percent of them municipalities, as shown in Table 2 (page 6). The states with the largest number of jurisdictions making use of the tax are Illinois, with 1,375, and Texas, with 1,029. The states with the highest percentage of local units using the tax are: Louisiana, Alaska, Utah, New Mexico, Alabama, and Virginia.

The map (page 8) shows the states with local governments making use of the local sales tax in 1988. Although there is no clear overall geographic pattern, there are some patterns for those states with large numbers of sales tax jurisdictions. Of the 18 states in which 100 or more local governments use the tax, 7 are southern states (Alabama, Georgia, Louisiana, North Carolina, Tennessee, Texas, and Virginia); 5 are Mississippi Valley states (Arkansas, Illinois, Kansas, Missouri, and Oklahoma); 5 are western states (California, Colorado, New Mexico, Utah, and Washington), and the other one is South Dakota. The tax is almost unused in the Northeast and much of the Midwest. To some extent, the lack of use in the Northeast reflects higher state sales tax rates in that region as well as concern about loss of sales along state borders; it is easier to impose a local sales tax if the practice is already established in adjacent states, and in regions where states are larger in area and less densely populated, thereby reducing the border sales problem.¹³

Revenue Significance

The local sales tax is a significant local government revenue source in many states. As shown in Table 3 (page 10), the local general sales tax accounts for 7 percent of all local (excluding the District of Columbia) own-source revenues, but the revenue significance varies considerably from state to state and from one type of local government to another. For those states where the local sales tax is used, the tax yields from less than .1 percent to 26 percent of all local own-source revenues, and up to 48 percent of local tax revenue in Louisiana.¹⁴ The tax accounts for 10 percent or more of all own-source revenues in 13 states, and 15 percent or more in 5 states.

The share of local sales tax revenues in the revenues of local general purpose governments (cities and counties) is even more impressive; however, the relative importance of the local sales tax compared to other local revenue sources varies considerably both among and within states and among size classes of cities and counties. For example, in 1987, local sales tax revenues accounted for 17 percent of nationwide municipal tax revenues and 9 percent of own-source revenues. But in six states (Alabama, Arizona, Colorado, Louisiana, Oklahoma, and South Dakota), local sales taxes are roughly one-half or more of city tax revenues and one-quarter or more of own-source revenues. Local sales tax revenues made up 16 percent of county tax revenues and 9 percent of county own-source revenues nationwide, but in six states (Alabama, Georgia, Missouri, New York, North Carolina, and Tennessee) they accounted for roughly one-third or more of county tax revenues and 20 percent or more of own-source revenues. Louisiana is the only state where special districts derive a significant proportion of their revenue from sales taxes; 56 percent for school districts and 88 percent for special districts.

Table 2

Number and Percentage of Local Jurisdictions Using Sales Tax, 1987, by State and Type of Jurisdiction

State	Municipalities and Townships		Counties		Special Districts		All Local Governments	
	Number	Percent	Number	Percent	Number	Percent	Number	Percent
Alabama	326	75%	56	84%	0	0%	382	36%
Alaska	87	58	6 ¹	67	0	0	93	54
Arizona	75	93	2	13	0	0	77	13
Arkansas	76	16	35	47	0	0	111	8
California	380	86	58	100	7 ²	< 1	445	10
Colorado	193	73	31	50	1 ²	< 1	225	14
Connecticut	0	0	0	0	0	0	0	0
Delaware	0	0	0	0	0	0	0	0
Florida ⁶	0	0	0	0	0	0	0	0
Georgia	0	0	143	91	1 ²	< 1	144	11
Hawaii	0	0	0	0	0	0	0	0
Idaho	0	0	0	0	0	0	0	0
Illinois	1,271	47	102	100	2 ²	< 1	1,375	21
Indiana	0	0	0	0	0	0	0	0
Iowa	23	2	0	0	0	0	23	1
Kansas	108	5	60	57	0	0	168	4
Kentucky	0	0	0	0	0	0	0	0
Louisiana	192	64	63 ³	100	70 ⁴	78	325	72
Maine	0	0	0	0	0	0	0	0
Maryland	0	0	0	0	0	0	0	0
Massachusetts	0	0	0	0	0	0	0	0
Michigan	0	0	0	0	0	0	0	0
Minnesota	3	< 1	0	0	0	0	3	< 1
Mississippi	0	0	0	0	0	0	0	0
Missouri	474	38	114	100	69 ²	4	657	21
Montana	0	0	0	0	0	0	0	0
Nebraska	22	2	0	0	0	0	22	1
Nevada	0	0	7 ⁵	44	0	0	7	4

New Hampshire	0	0	0	0	0	0	0	0
New Jersey	0	0	0	0	0	0	0	0
New Mexico	100	100	28	85	0	0	128	39
New York	26	2	58	100	0	0	84	3
North Carolina	0	0	100	100	0	0	100	11
North Dakota	3	< 1	0	0	0	0	3	< 1
Ohio	0	0	79	90	2 ²	< 1	81	2
Oklahoma	457	77	16	21	0	0	473	26
Oregon	0	0	0	0	0	0	0	0
Pennsylvania	0	0	0	0	0	0	0	0
Rhode Island	0	0	0	0	0	0	0	0
South Carolina	0	0	0	0	0	0	0	0
South Dakota	111	9	0	0	0	0	111	6
Tennessee	10	3	95	100	0	0	105	12
Texas ⁶	1,023	88	0	0	6 ²	< 1	1,029	23
Utah ⁶	219	97	29	100	0	0	248	47
Vermont	0	0	0	0	0	0	0	0
Virginia	41	18	95	100	0	0	136	32
Washington	268	100	39	100	0	0	307	17
West Virginia	0	0	0	0	0	0	0	0
Wisconsin	0	0	12	17	0	0	12	< 1
Wyoming	0	0	15	65	0	0	15	4
U.S. Total	5,488	15	1,243	41	158	< 1	6,889	8

Note: In a few cases, the number of jurisdictions reported using the local sales tax was greater than the number of jurisdictions of that type enumerated by the Census. In those cases, 100% usage is shown.

¹ Boroughs

² Transit or transportation districts

³ Parishes

⁴ School districts (47) and other special districts (23)

⁵ Includes only counties levying optional local sales tax.

⁶In 1988, additional types of jurisdictions began using the tax, as follows:

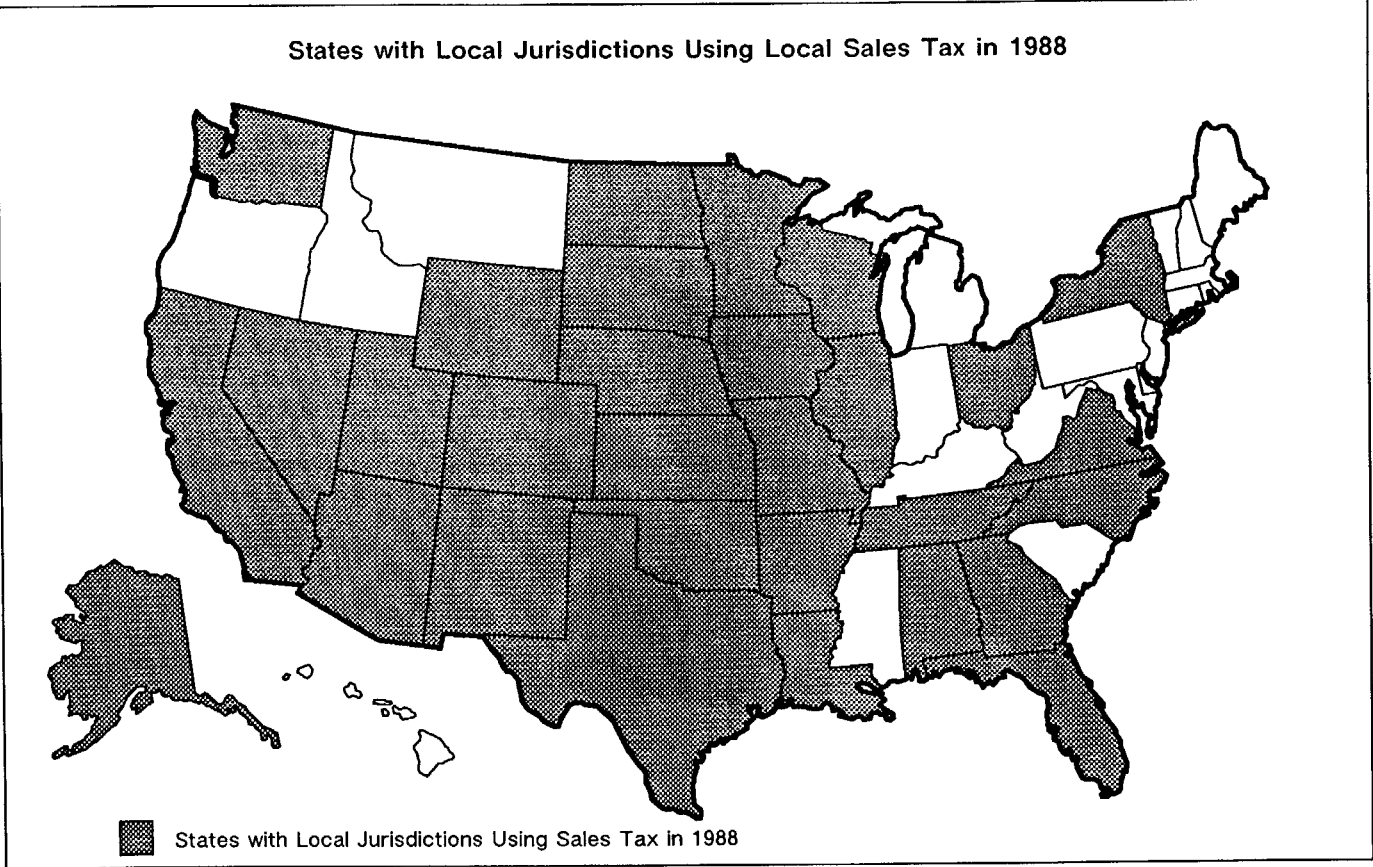
Florida—10 counties

Texas—78 counties

Utah—7 transportation districts.

Sources: Updated from Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1989 Edition, Volume I, January 1989.

States with Local Jurisdictions Using Local Sales Tax in 1988



For the ten largest cities and counties making use of the tax, its share of this tax in local own-source revenues ranges from 4 percent to 13 percent for cities and from less than 1 percent to 32 percent for counties (see Table 4). However, the local sales tax as a share of total local own-source revenues is highest among cities in the 500,000 to 1 million population range. As a share of tax revenues, it is most important to the cities with populations of 100,000 to 500,000. Per capita sales tax revenues are strikingly higher in the largest cities, reflecting, in most cases, their roles as commercial centers for the surrounding area, rather than high tax rates. In general, the tax is most heavily used by the cities and counties just below the largest size range, but it is also a significant revenue source for some of the nation's largest cities and counties, as shown in Table 4 (page 12).

Local Sales Tax Rates

The permitted rate or range of local rates is usually established by the state. The range of rates for local sales taxes is large, but local rates are generally lower than state sales tax rates. As indicated in Table 5 (page 14), with few exceptions, local rates tend to range between 0.5 percent and 3 percent, while the average state rate is in the 4-to-6 percent range. At present, the New Orleans rate of 5 percent and the combined local rates of 4.25 percent in New York City and in Yonkers, all exceeding the 4 percent sales tax rate of their parent states, are the highest local sales tax rates in the nation. Competition from nearby jurisdictions places some constraints on sales tax rates, and the extensive use of local sales taxes at high rates may constrain the state's use of sales taxes as a revenue source, or vice versa. Many states attempt to resolve this problem with a cap on local rates.

Use of Local Sales Tax Revenues

While most local sales taxes go into the general funds of municipalities or counties for general government support, in some cases the revenue is dedicated to more specific purposes. As noted above, in Louisiana the local sales tax is the main support of the schools. A number of states permit use of the local sales tax to fund transit districts. In Nevada, nearly two-thirds of the statewide 5.75 percent sales tax is earmarked, partly for schools and partly for local property tax relief; seven counties levy an additional amount for public transportation, road construction, or tourism.¹⁵ The Florida local sales tax, created in 1987 and in place in 10 counties, must be used for infrastructure.¹⁶

Table 3
**Local Sales Tax Collections as a Percentage
of Own-Source Revenues, FY 1987, by State and Type of Jurisdiction**

State	Municipalities and Townships		Counties		Special Districts		All Local Governments	
	Collections (thousands)	Percent of Revenue	Collections (thousands)	Percent of Revenue	Collections (thousands)	Percent of Revenue	Collections (thousands)	Percent of Revenue
Alabama	\$340,733	25%	\$116,718	24%	0	0%	\$457,451	17%
Alaska	44,121	6	11,214	2	0	0	55,335	5
Arizona	329,127	26	0	0	0	0	329,127	9
Arkansas	47,331	12	13,107	3	0	0	60,438	5
California	1,993,448	16	331,244	4	446,762	4	2,771,454	9
Colorado	550,406	33	61,129	7	77,941	4	689,476	15
Connecticut	0	0	0	0	0	0	0	0
Delaware	0	0	0	0	0	0	0	0
Florida	0	0	37,118	1	0	0	37,118	0
Georgia	0	0	648,014	31	0	0	648,014	10
Hawaii	0	0	0	0	0	0	0	0
Idaho	0	0	0	0	0	0	0	0
Illinois	809,394	19	54,062	4	354,498	6	1,217,954	10
Indiana	0	0	0	0	0	0	0	0
Iowa	1,611	0	0	0	0	0	1,611	0
Kansas	86,022	6	105,069	13	0	0	191,091	6
Kentucky	0	0	0	0	0	0	0	0
Louisiana	345,976	26	195,920	13	433,195	48	975,091	26
Maine	0	0	0	0	0	0	0	0
Maryland	0	0	0	0	0	0	0	0
Massachusetts	0	0	0	0	0	0	0	0
Michigan	0	0	0	0	0	0	0	0
Minnesota	11,118	0	0	0	0	0	11,118	0
Mississippi	0	0	304	0	2	0	306	0

Missouri	263,792	17	254,780	30	0	0	518,572	13
Montana	0	0	0	0	0	0	0	0
Nebraska	67,000	15	547	0	0	0	67,547	4
Nevada	0	0	5,806	1	0	0	5,806	1
New Hampshire	0	0	0	0	0	0	0	0
New Jersey	0	0	0	0	0	0	0	0
New Mexico	84,198	14	34,555	14	0	0	118,753	12
New York	2,231,042	11	2,152,976	35	0	0	4,384,018	13
North Carolina	0	0	627,699	21	0	0	627,699	14
North Dakota	6,418	3	0	0	0	0	6,418	1
Ohio	0	0	297,542	13	121,964	3	419,506	4
Oklahoma	430,395	32	5,790	1	0	0	436,185	18
Oregon	0	0	0	0	0	0	0	0
Pennsylvania	0	0	0	0	0	0	0	0
Rhode Island	0	0	0	0	0	0	0	0
South Carolina	0	0	0	0	0	0	0	0
South Dakota	51,837	27	0	0	8,025	3	59,862	10
Tennessee	128,587	9	452,900	21	0	0	581,487	15
Texas	894,160	14	687	0	230,835	3	1,125,682	6
Utah	86,822	19	36,673	9	0	0	123,495	8
Vermont	0	0	0	0	0	0	0	0
Virginia	173,925	8	203,892	8	0	0	377,817	7
Washington	210,149	16	105,507	12	101,189	6	416,845	10
West Virginia	0	0	0	0	0	0	0	0
Wisconsin	0	0	0	0	0	0	0	0
Wyoming	0	0	40,439	10	0	0	40,439	5
U.S. Total	9,187,612	9	5,793,692	9	1,774,411	2	16,755,715	7

Source: U.S. Department of Commerce, Bureau of the Census, *Government Finances in 1986-87* (Washington, DC: November 1988), Table 29.

Table 4

**Percentage Distribution of Revenue Sources for the 10 Largest Cities and Counties
with and without Local Sales Tax, FY 1987**

City	Sales Tax Revenue	Property Tax Revenue	Income Tax Revenue	State Aid	Other Local Revenue ¹	Total General Revenue (thousands)	EXHIBITS	
							Population	Population Rank
Cities with Local Sales Tax								
New York, NY	8.0%	19.1%	15.0%	33.1%	24.7%	\$26,319,470	7,262,747	1
Los Angeles, CA	9.2	17.7	0.0	9.7	63.3	2,675,466	3,259,295	2
Chicago, IL	10.5	16.3	0.0	15.7	57.5	2,348,135	3,009,528	3
Houston, TX	10.8	29.3	0.0	2.8	57.1	1,247,496	1,728,911	4
San Diego, CA	11.4	12.1	0.0	9.4	67.1	790,737	1,015,191	7
Dallas, TX	13.2	28.0	0.0	1.6	57.3	817,303	1,003,519	8
San Antonio, TX	10.2	15.4	0.0	3.3	71.1	574,722	914,354	9
Phoenix, AZ	13.0	10.1	0.0	20.9	56.1	829,864	894,065	10
San Francisco, CA	3.8	18.7	0.0	26.3	51.2	1,922,045	748,959	12
San Jose, CA	11.1	17.7	0.0	11.0	60.1	518,204	712,079	14
Cities without Local Sales Tax								
Philadelphia, PA	0.0	11.7	37.8	15.4	35.0	2,205,503	1,642,854	5
Detroit, MI	0.0	12.2	18.3	30.0	39.5	1,445,622	1,086,216	6
Baltimore, MD	0.0	23.0	6.6	41.3	29.1	1,537,644	752,803	11
Indianapolis, IN	0.0	30.0	2.6	26.6	40.8	646,693	719,820	13
Memphis, TN	0.0	15.7	0.0	32.7	51.6	687,020	652,636	15
Jacksonville, FL	0.0	18.2	0.0	10.9	70.8	704,781	610,025	16
Milwaukee, WI	0.0	23.4	0.0	41.9	34.8	517,787	605,085	17
Boston, MA	0.0	33.3	0.0	44.2	22.5	1,298,624	573,604	18
Columbus, OH	0.0	4.7	44.8	9.2	41.3	396,515	566,030	19
Cleveland, OH	0.0	9.8	40.1	10.6	39.5	433,772	535,826	20

Counties with Local Sales Tax

Los Angeles, CA	0.7	25.2	0.0	55.6	18.5	6,340,848	8,296,118	1
Cook, IL	0.3	39.5	0.0	20.7	39.5	974,431	5,297,907	2
San Diego, CA	1.0	23.3	0.0	56.3	19.4	1,104,200	2,201,316	4
Orange, CA	1.5	25.8	0.0	41.4	31.4	1,208,966	2,166,801	6
Cuyahoga, OH	5.3	17.6	0.0	42.4	34.7	766,134	1,445,391	10
Santa Clara, CA	4.9	21.3	0.0	46.2	27.6	1,176,488	1,404,637	11
King, WA	7.4	29.4	0.0	19.5	43.7	485,885	1,362,294	14
Nassau, NY	28.5	29.9	0.0	18.7	22.9	1,452,603	1,323,037	15
Suffolk, NY	31.9	26.5	0.0	24.3	17.3	1,032,364	1,312,030	16
Alameda, CA	1.1	20.8	0.0	61.0	17.2	852,058	1,208,693	17

Counties without Local Sales Tax

Harris, TX	0.0	49.4	0.0	4.9	45.7	1,152,722	2,798,298	3
Wayne, MI	0.0	21.4	0.0	37.2	41.4	623,566	2,174,950	5
Maricopa, AZ	0.0	25.4	0.0	34.0	40.6	773,829	1,885,367	7
Dallas, TX	0.0	46.8	0.0	7.5	45.7	423,600	1,833,095	8
Dade, FL	0.0	25.2	0.0	10.1	64.7	1,863,519	1,769,529	9
Allegheny, PA	0.0	39.4	0.0	37.6	23.0	530,694	1,373,596	12
Middlesex, MA	0.0	32.5	0.0	24.0	43.5	49,015	1,367,045	13
Bexar, TX	0.0	39.2	0.0	5.1	55.7	274,199	1,169,081	18
Broward, FL	0.0	28.2	0.0	11.4	60.5	576,560	1,142,737	19
Tarrant, TX	0.0	37.6	0.0	10.3	52.1	211,298	1,101,487	20

¹Includes selective sales taxes, license revenues, charges, interest earnings, special assessments, federal intergovernmental revenue, and other general revenue.

Sources: U.S. Department of Commerce, Bureau of the Census, *City Government Finances in 1986-87*, Table 7; and *County Government Finances in 1986-87*, Table 7 (Washington, DC: March 1989).

Table 5

Range of Local, State, and Combined General Sales Tax Rates for Selected Jurisdictions, October 1988

State	City Name (county)	State Tax	County Tax	City Tax	Other Tax	Combined State-Local Sales Tax Rate
Alabama	Birmingham (Jefferson)	4.0%	1.0%	2.0%		7.0%
	Huntsville (Madison)	4.0	1.0	3.0		8.0
	Mobile (Mobile)	4.0		3.0		7.0
	Montgomery (Montgomery)	4.0	1.5	2.0		7.5
Alaska	Anchorage (Anchorage)	0.0				0.0
	Juneau (Juneau)	0.0		4.0		4.0
Arizona	Phoenix (Maricopa)	5.0		1.2	0.5	6.7
	Tucson (Pima)	5.0		2.0		7.0
Arkansas	Fayetteville (Washington)	4.0	1.0	1.0		6.0
	Fort Smith (Sebastian)	4.0		1.0		5.0
	Little Rock (Pulaski)	4.0	1.0			5.0
California	Los Angeles (Los Angeles)	4.75	1.25		0.5	6.5
	Long Beach (Los Angeles)	4.75	1.25		0.5	6.5
	Oakland (Alameda)	4.75	1.25		1.0	7.0
	Sacramento (Sacramento)	4.75	1.25			6.0
	San Diego (San Diego)	4.75	1.25			6.0
	San Francisco (San Francisco)	4.75	1.25		0.5	6.5
	San Jose (Santa Clara)	4.75	1.25		1.0	7.0
	Colorado Springs (El Paso)	3.0	1.0	2.5		6.5
Colorado	Denver (Denver)	3.0	3.5		0.6	7.1
	Golden (Jefferson)	3.0	0.5	2.0	0.6	6.1
	Pueblo (Pueblo)	3.0		3.5		6.5
Connecticut	No local general sales taxes	7.5				7.5
Delaware	No state or local general sales taxes	0.0				0.0
District of Columbia	(not applicable)	n.a.		6.0		6.0

Florida	No local general sales tax	5.0				5.0
Georgia	Atlanta (Fulton)	3.0	1.0		1.0	5.0
	Columbus (Muscogee)	3.0	2.0			5.0
	Macon (Bibb)	3.0	1.0			4.0
Hawaii	No local general sales taxes	4.0				4.0
Idaho	No local general sales taxes	5.0				5.0
Illinois	Chicago (Cook)	5.0	1.0	2.0	1.0	9.0
	Rockford (Winnebago)	5.0	1.25	1.0		7.25
Indiana	No local general sales tax	5.0				5.0
Iowa	Sioux City (Woodbury)	4.0		1.0		5.0
Kansas	Kansas City (Wyandotte)	4.0	1.0	1.0		6.0
	Topeka (Shawnee)	4.0		1.0		5.0
	Wichita (Sedgwick)	4.0	1.0			5.0
Kentucky	No local general sales taxes	5.0				5.0
Louisiana	Baton Rouge (E. Baton Rouge)	4.0	3.0			7.0
	Monroe (Ouachita)	4.0	0.5	2.5		7.0
	New Orleans (Orleans)	4.0	5.0			9.0
	Shreveport (Caddo)	4.0	1.5	2.0		7.5
Maine	No local general sales taxes	5.0				5.0
Maryland	No local general sales taxes	5.0				5.0
Massachusetts	No local general sales taxes	5.0				5.0
Michigan	No local general sales taxes	4.0				4.0
Minnesota	Duluth (St. Louis)	6.0		1.0		7.0
	Minneapolis (Hennepin)	6.0		0.5		6.5
Mississippi	No local general sales taxes	6.0				6.0
Missouri	Kansas City (Jackson)	4.225	0.5	1.0	0.5	6.225
	St. Louis City	4.225		1.375	0.5	6.100
	Springfield (Greene)	4.225	0.5	1.0		5.725
Montana	No state or local general sales taxes	0.0				0.0

Table 5 (cont.)

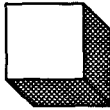
Range of Local, State, and Combined General Sales Tax Rates for Selected Jurisdictions, October 1988

State	City Name (county)	State Tax	County Tax	City Tax	Other Tax	Combined State-Local Sales Tax Rate
Nebraska	Omaha (Douglas)	4.0		1.5		5.5
Nevada	Las Vegas (Clark)	5.75	0.25			6.0
	Reno (Washoe)	5.75	0.25		0.25	6.25
New Hampshire	No state or local general sales taxes	0.0				0.0
New Jersey	No local general sales taxes	6.0				6.0
New Mexico	Albuquerque (Bernalillo)	4.75		0.25		5.0
	Santa Fe (Santa Fe)	4.75		0.625		5.375
New York	Buffalo (Erie)	4.0	4.0			8.0
	New York City	4.0		4.0	0.25	8.25
	Rochester (Monroe)	4.0	3.0			7.0
	Yonkers (Westchester)	4.0	1.5	2.5	0.25	8.25
North Carolina	Charlotte (Mecklenburg)	3.0	2.0			5.0
North Dakota	Bismarck (Burleigh)	6.0		1.0		7.0
	Fargo (Cass)	6.0		0.5		6.5
Ohio	Cincinnati (Hamilton)	5.0	0.5			5.5
	Cleveland (Cuyahoga)	5.0	1.0		1.0	7.0
	Columbus (Franklin)	5.0	0.5			5.5
	Dayton (Montgomery)	5.0	0.5		0.5	6.0
	Toledo (Lucas)	5.0	1.0			6.0
Oklahoma	Tahlequah (Cherokee)	4.0	1.0	2.0		7.0
	Oklahoma City (Canadian)	4.0		2.0		6.0
	Okmulgee (Okmulgee)	4.0	1.0	3.5		8.5
	Tulsa (Tulsa)	4.0		3.0		7.0
Oregon	No state or local general sales taxes	0.0				0.0
Pennsylvania	No local general sales tax	6.0				6.0

Rhode Island	No local general sales taxes	6.0			6.0
South Carolina	No local general sales taxes	5.0			5.0
South Dakota	Sioux Falls (Minnehaha)	4.0		2.0	6.0
	Pierre (Hughes)	4.0		1.0	5.0
Tennessee	Chattanooga (Hamilton)	5.5	1.75		7.25
	Knoxville (Knox)	5.5	1.5		7.0
	Memphis (Shelby)	5.5	2.25		7.75
	Nashville (Davidson)	5.5	2.25		7.75
Texas	Austin (Travis)	6.0		1.0	1.0
	Dallas (Dallas)	6.0		1.0	1.0
	El Paso (El Paso)	6.0	0.5	1.0	0.5
	Fort Worth (Tarrant)	6.0		1.0	0.25
	Houston (Harris)	6.0		1.0	1.0
	Lubbock (Lubbock)	6.0	0.5	1.0	1.0
	Pasadena (Harris)	6.0		1.0	1.0
	San Antonio (Bexar)	6.0		1.0	1.0
Utah	Salt Lake City (Salt Lake)	5.0938		0.91	0.25
Vermont	No local general sales taxes	4.0			4.0
Virginia ¹	Norfolk	3.5		1.0	4.5
	Virginia Beach	3.5		1.0	4.5
	Fairfax County	3.5	1.0		4.5
Washington	Seattle (King)	6.5		1.6	8.1
	Spokane (Spokane)	6.5		1.3	7.8
West Virginia	No local general sales taxes	6.0			6.0
Wisconsin	Menomonie (Dunn)	5.0	0.5		5.5
	Milwaukee (Milwaukee)	5.0			5.0
Wyoming	Cheyenne (Laramie)	3.0	2.0		5.0
	Casper (Natrona)	3.0	1.0		4.0

¹Cities are independent of counties.

Source: Updated from Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, 1989 Edition, Volume I, January 1989, Table 28.



Rationales for the Local Sales Tax

Local governments use nonproperty taxes for at least four major reasons:

1. *Revenue diversification*: to minimize the adverse effects of any one tax and to make the tax structure more flexible and responsive to local circumstances.

2. *Indirect property tax relief*: to obtain additional revenue while avoiding higher property or other taxes.

3. *Benefits taxation*: to broaden the distribution of the local tax burden to include more of those who benefit from local public services (e.g., nonresident consumers).

4. *Ability-to-pay taxation*: to relate tax burdens more closely to taxpayers' total financial capacity.

This section examines these rationales for local sales taxation, and the extent to which local sales taxes actually meet these goals.

The Local Sales Tax and Local Revenue Diversification

The local sales tax can play an important role as a complement to other local revenue sources. At the same time, the use of a local sales tax usually means less reliance on property and/or local income taxes. Thus, the merits and drawbacks of using the local sales tax for revenue diversification must be evaluated not only independently but also in comparison to these two other major taxes.

Yield. Like the property tax and local income tax, the local sales tax can be a highly productive source of revenue. The revenue yield of this tax depends not only on the rate but also on the structure of the tax base and the level of retail activity in the taxing jurisdiction. For these reasons, revenue yields may vary greatly, even within a state. For example, in Virginia, where the local sales tax is used statewide at a uniform 1 percent rate, cities of 50,000 or more reported sales tax revenues in 1985-86 ranging from \$47 per capita in Portsmouth and Newport News to \$108 per capita in Roanoke.

Tax base exemptions affect the revenue yield of a sales tax significantly. For example, Due and Mikesell estimate that exemption of food consumed at home reduces the yield of a sales tax at the state level by 15 to 20 percent.¹⁷ In addition to differences in tax base, the spread in tax yields reflects differences in the level of retail activity, including the ability of some jurisdictions to

export the sales tax (i.e., collect taxes from nonresidents), for example, through tourism. When state sales tax revenue was measured per \$100 of personal income, the revenue yield per 1 percent of tax rate ranged from 31 cents in Massachusetts (closely followed by Pennsylvania at 32 cents) to \$1.45 in Hawaii, which has a very-broad based tax. The variation in yield among states is easily explained in terms of the breadth of the base and, in some cases, the opportunity to export through tourism or business travel.¹⁸

Elasticity. The sales tax tends to be relatively responsive to growth and fluctuations in income. This aspect of the tax makes it an attractive complement to a property tax. The property tax offers a stable revenue base during recessions, while sales tax revenue will be more likely to increase as economic activity increases. One of the reasons cited in the 1974 ACIR study for diversifying the local revenue base was that both sales taxes and income taxes are more responsive to economic growth and inflation than the property tax.¹⁹

Studies of state sales taxes show that a 1 percent increase in total income results in an increase in sales tax revenue between 0.8 percent and 1.27 percent; most frequently, the response is about 1 percent. Income taxes fluctuate more and property taxes, less.²⁰ Thus, the sales tax occupies an intermediate position, offering more stability but less sensitivity to growth and inflation than the income tax, and less stability but more responsiveness to growth than the property tax.

Fox and Campbell examined the elasticity of the sales tax base over the course of recessions and expansions and found that the overall base tends to fluctuate, although somewhat less than the fluctuations in total income. The elasticity of the components of the tax base varied significantly, however. Consumer durables were highly sensitive to ups and downs in income, while nondurables were highly stable. When income fell (or rose), the various components of the sales tax fell (or rose) by 16 percent to 92 percent of the percentage change in income.²¹

Efficiency. All taxes distort private economic decisions somewhat and therefore create inefficiencies, at least in a narrow sense. Sales taxes, for example, may discourage consumption and/or encourage the flight of commercial facilities to outside taxing jurisdictions. Although income and property taxes also affect economic decisions, local sales taxes are likely to have a more visible impact on those decisions; retailers are more likely to locate outside sales tax jurisdictions and shoppers more likely to go elsewhere to avoid local sales taxes than residents are to relocate because of property or income taxes.

To the extent that local taxes affect such consumption and production decisions and locational choices, lower rates on these taxes cause fewer distortions of economic decisions. Diversifying a jurisdiction's revenue base by levying a sales tax can help to keep all tax rates lower and thus reduce the amount of distortion from high rates on a particular tax.

Equity. The revenue diversification argument posits that using a greater variety of taxes can make the tax structure more equitable. The incidence (who ultimately bears the burden) of the general sales tax is shifted largely to consumers, and because consumption varies inversely with income, the tax is

regressive.²² However, some part of the tax, including compliance costs, falls on the vendor, and as a general rule, the more buyers have ready access to alternative sellers offering lower tax rates and therefore lower total prices, the more the burden of the local sales tax will fall on the vendor. This would be expected, for example, where local sales taxes are used by some, but not all jurisdictions within a state, or where shoppers can easily cross state borders into jurisdictions with lower—or no—sales taxes. While this issue was presented above as an efficiency argument, the presence of nontaxed alternatives also affects the ability of the seller to shift the tax forward to the buyer. To the extent that the tax falls on the vendor rather than the buyer, its incidence will be on owners and employees, which may or may not result in making the sales tax less regressive, depending on their income levels.

A diversified revenue base may make the local tax structure more equitable by spreading tax burdens. A local sales tax, by capturing revenues from consumers and vendors, may mitigate the burden on those with tangible property wealth but low income and low spending. This argument must be used with caution, however, because both the property tax and the sales tax are widely criticized as regressive. In terms of equity among residents of different places, local sales tax revenue yields are highly variable among jurisdictions because of differences in the amounts of retail sales activity, as indicated above. Studies confirm the disparities in local sales tax yield among localities within a state. In contrast, income taxes and property taxes may offer a more geographically even distribution of the tax base. Thus, the local sales tax is at best a weak tool and at worst a perverse one for purposes of fiscal equalization among jurisdictions. In fact, to the extent that the use of local sales taxes makes it more difficult for a state to increase its sales tax rate and thus to fund equalizing revenues or services among localities, the local sales tax may be indirectly disequalizing. However, some states correct for this tendency by distributing revenues according to a formula that does not return all sales tax revenues to the point of origin, but rather redistributes some to areas with less retail activity. While such state redistribution reduces the genuinely local character of the tax, it also reduces its disequalizing impact.

The ACIR considered the relationship of local sales taxes to fiscal equalization in its 1961 and 1974 studies. In 1974, ACIR concluded that the sales tax is not a suitable vehicle for fiscal equalization. However, the Commission pointed out that the local sales tax should not be denied a place in the local revenue structure because of its shortcomings as a means of fiscal equalization. Fiscal equalization, ACIR concluded, could be approached with other, more suitable tools.²³

Administrative and Compliance Costs. Like all taxes, the local general sales tax creates administrative costs for the government and collection/compliance costs for payers, in this case, retailers. Administrative costs for local sales taxes are not available, but some sense of the cost can be derived from experience with state general sales taxes. According to Due and Mikesell, the cost of administering this tax ranges from 0.30 percent of revenue in Arizona to 1.68 percent in Nevada, with a median of 0.73 percent nationwide.²⁴ Administra-

tive costs as a percentage of revenue can be expected to be higher where there are more exemptions from the base, where rates are lower, and where administration is done locally, especially if the base and exemptions differ from the state tax.

The local sales tax is probably comparable to a payroll or piggyback income tax in administrative cost. The local sales tax is generally easier to administer than the property tax, and lends itself easily to state administration. Adding a new or different tax (e.g., adding a local sales tax in a community that currently has only a property tax) will increase administrative costs more than a comparable increase in an existing tax because the added tax requires the retailer to maintain different records and the tax administrator to establish new collection procedures.

A principal complaint about the general sales tax is the compliance cost for retailers, particularly small retailers, since there are substantial economies of scale in keeping sales tax records. Relatively little information exists about actual vendor compliance costs. One study found an average cost of 3.93 percent of tax due as the compliance cost. Costs were highest for smaller stores and those with a high percentage of exempt items.²⁵ Another estimate indicated that compliance costs for a department store under a 4 percent tax rate are about 2.51 percent of tax liability.²⁶

Generally, the higher the tax rate, the lower the compliance costs will be as a percentage of the tax liability. The compliance cost also rises with the number and variety of exemptions, both exempt items and exempt buyers, because additional documentation is required to separate exempt from non-exempt sales. However, where there is a state general sales tax, the additional compliance cost from a local sales tax is generally minimal as long as the base of the local tax conforms to the base of the state tax. Some states provide compensation to vendors for their compliance and/or collection costs, thereby reducing the net cost, but other state and local sales tax compliance costs fall entirely on the vendor.

Acceptability. The 1987 ACIR public opinion poll found that the sales tax was one of the most acceptable ways to increase government collections—only user fees outranked sales taxes at all three levels of government. At the local level, the sales tax was the second choice after user fees and charges, and was strongly preferred to either a local income tax or higher property taxes. The sales tax has remained a strong popular choice year after year in the survey, although its ranking and percentage dropped in 1987 when a wider array of options was offered.²⁷

An earlier poll (1983) observed that:

The growing preference for sales taxes might be attributed in large part to the growing burden of payroll taxes (income taxes and social security), the perceived inequities in the present income tax, and the long-standing public resistance to more intensive use of the property tax. Support for sales taxes can also be attributed to the fact that they are paid frequently and in small amounts. Moreover, many taxpayers

like the idea that they can control somewhat the size of their payments by saving rather than consuming and that all citizens are paying something.²⁸

When respondents in the 1989 poll were asked which among the federal income tax, state income tax, state sales tax, and local property tax was “the worst tax—that is, the least fair,” the local property tax was ranked the worst (by 32 percent). The federal income tax, which since 1978 was either ranked worst or tied with the local property tax as the most unpopular, dropped to second place (27 percent). The state sales tax was third at 18 percent, and the state income tax continued to enjoy the least unfavorable rating.²⁹ These data suggest that the continued unpopularity of the property tax relative to state income and sales taxes may explain continued interest in and expansion of local nonproperty taxes, particularly the local sales tax.

Risk Spreading. A diversified tax base can offer a state or local government the same advantages that a diversified portfolio of financial assets offers to individual investors. Any particular tax offers strengths and weaknesses in terms of stability, growth, sensitivity to inflation, and other aspects of economic change. A diversified revenue base can offer a better mix of such attributes than a revenue structure that depends on a single tax.³⁰

The arguments for sales tax diversification must be applied with caution to local jurisdictions. The ability of a local government to implement a local sales tax successfully depends critically on its relationship to its surroundings. If the tax is also used in adjacent jurisdictions, there is less likelihood of distorting locational and other economic decisions. If the tax is unique to the jurisdiction, then the local government must weigh the expected revenue gains against the possible long-run losses in business firms and economic activity to non-sales tax areas.

The Local Sales Tax as Tax Relief

Although the local sales tax is often advocated as a way to provide property tax relief, there is some debate as to whether it actually performs this function. Preliminary evidence from a recent study does suggest such relief.³¹ However, as shown in Table 4, at least for the 20 largest cities, there is little evidence that cities with sales taxes raise a substantially smaller portion of their revenue from property taxes than cities without sales taxes. For counties, the use of a sales tax does seem to reduce somewhat the reliance on property taxes as a proportion of total revenue.

The local sales tax may also provide state rather than local tax relief by shifting some of the responsibility for raising revenue for local services from state (and federal) aid to local taxes. Table 4 indicates that among the 20 largest cities, use of a sales tax tends to be associated with lessened reliance on state aid. However, among the 20 largest counties, the pattern appears to be just the opposite. Thus, the evidence on sales taxation as relief for property taxes or state aid appears to be mixed. It is interesting to note that sales taxation appears to substitute for income taxation in large cities; only one of

the ten largest cities with a sales tax also used the local income tax, while six of the largest cities without a sales tax used income taxation.

The Local Sales Tax as a Benefit Tax

The benefit principle of taxation holds that those who benefit from publicly provided goods and services should bear the burden of their cost in proportion to the benefits received. Whereas the property tax is sometimes justified on the benefit principle (because many local services, such as police, fire, sanitation, and street maintenance can be regarded as services to property, whose value to the taxpayer is roughly proportional to the value of property owned), the sales tax, like the income tax, has only a tenuous justification based on a benefit principle of taxation.³²

A case can be (and has been) made that it is appropriate under the benefits principle to levy taxes on purchases by both residents and nonresidents who shop in the local jurisdiction. The argument is that those who shop in the central city, including many commuters and tourists, use the services of local government: they park in public parking lots, walk the streets, generate trash, consume the city's cultural services, such as museums, and benefit from fire and police protection. Those who live outside the city, however, generate little in the way of tax revenue to any local government whose only source of local tax revenue is the property tax. Thus, one way to charge for the services that these people enjoy is through a sales tax that is paid in part by nonresident shoppers.³³ The benefit principle applies particularly well to a sales tax levied by a transit district that ferries shoppers and commuters into and out of the central city, a fact that may help account for the rapid spread of such taxes at modest rates in large cities. Such a clear identification of the benefits with the users also helps to make the tax more politically acceptable.

The issue of whether, in fact, residents of the suburbs are exploiting the cultural amenities and other services provided by the central city and should therefore contribute to its revenues is disputed. King, looking at the issue theoretically and across a number of federal countries, concludes that capturing externalities generated by the city is necessary in order to generate the desirable level of local public services.³⁴ Bradford and Oates, on the other hand, attempt to address empirically the distribution of benefits between suburban and central city residents. They find that most local taxes support services to residents, especially the public schools, which do not benefit nonresidents very much. Green, Scott, and Neenan point out, however, that if public service benefits are measured on a basis of what people are willing to pay for services that they receive indirectly as well as directly, there may be a net fiscal flow from city to suburb. This is explained largely by the fact that the metropolitanwide benefits of poverty and health-related public expenditures fall disproportionately on the central city's budget. Thus, there is a net benefit flow from city to suburb which, in turn, leads to a conclusion that suburban nonresidents do indirectly benefit from central city direct expenditures.³⁵

The portion of the sales tax falling on the seller rather than the buyer is easier to justify on the benefit principle because the vendor enjoys all the

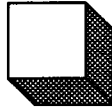
municipal services that support the operation and bring in customers. However, it is difficult to argue that the sales tax—or the part of it that falls on the seller—is apportioned among sellers in proportion to either the cost of services provided or the value of services received. Some sellers create large service demands but generate little sales tax revenue, while others require few services but have a high volume of taxable sales. Thus, the local sales tax has elements of a benefit tax, but cannot be justified on that basis alone.

The Local Sales Tax as an Ability-to-Pay Tax

The ability-to-pay principle of taxation reflects the idea that taxpayers should contribute to the support of public goods in proportion to their financial capacity. Ability to pay is widely interpreted to imply a proportional or progressive tax (i.e., one for which the tax burden rises in proportion to or faster than income as income rises).

The sales tax is not commonly justified on the basis of ability to pay because state and local sales taxes are generally believed to be regressive. That is, the percentage of income that is paid in tax is higher for lower income families, especially when food is taxed and services are exempted.³⁶ Only about half of the states with local sales taxes have state sales taxes that exempt food (although 29 of the 45 states and the District of Columbia with state sales taxes exempt food). Since local sales tax bases generally parallel the state tax base, these regressive state sales taxes become regressive local sales taxes.

On the other hand, an adequate measure of ability to pay might need to incorporate variables other than earned income. For one, it is possible to conceal income from the tax collector by a host of means, some legitimate and some not. Also, even current money income is not a good proxy for longer term income and thus for ability to pay taxes. The two most widely used alternative (or complementary) measures of ability to pay are wealth and consumer expenditures. The property tax captures the wealth component, albeit imperfectly; the sales tax captures some part of the expenditure measure of ability to pay. Thus, this argument provides some basis for considering the sales tax an ability-to-pay tax.



Design Issues in Local Sales Taxation

Public finance analysts have identified a number of key issues for state and local governments in the design of a local sales tax system.³⁷ Many of these issues are intergovernmental in nature, having to do with the desirability of state oversight of the local sales tax and local variability in sales tax policy and administration. Past ACIR recommendations on a number of these issues are presented at the end of this section.

Universal v. Local Option

States and local governments have the choice of requiring all local jurisdictions (or all jurisdictions of a particular type) to use a local sales tax or of giving local jurisdictions the option of using the tax. A related issue is whether the local sales tax rate should be mandated by the state or determined by the local jurisdictions within a range of rates.

A universal local sales tax at a mandated rate is, in effect, a state tax that is shared with local government on the basis of where the sale is made. There are only two states in which all jurisdictions of a specified type use the tax at a specified rate. In Virginia, all cities and counties are required by the state to impose a 1 percent local sales tax; in California, all counties are required to have a 1.25 percent sales tax.³⁸ The universal local tax has the advantage of minimizing distortions in locational choice within the state, although it does not necessarily relieve border-city problems (see below). Such a tax also means lower administrative costs for the government and lower compliance costs for the retailer. However, the distribution of revenues bears no necessary relation to local needs or local preferences.

Two states require universal use of the local sales tax but permit some degree of flexibility in the rates. In New Mexico, all incorporated cities have a local sales tax, but with varying rates up to 1 percent. All counties in Tennessee have a local sales tax at a rate not to exceed one-half the state rate.

A local option as to whether to employ the tax, or what rate to use, allows local governments to adapt the tax to their circumstances. In general, states have leaned toward more local flexibility in rates and in the decision as to whether to use the tax: local option within a range of rates specified by the state is the most common form of local sales tax. At the same time, most states limit their local governments' freedom to use different bases or to charge local use taxes (see below) in order to minimize compliance costs and to facilitate state rather than local administration.

The Local Tax Base

Most, but not all, states require that the local sales tax be applied to the same set of items as the state sales tax. That is, if food, utilities, or services are taxed (or exempt) at the state level, they are normally treated the same way at the local level. Major exceptions occur in seven states. Food exemptions differ between state and local sales taxes in Arizona, Colorado, South Dakota, and Louisiana. State and local energy exemptions differ in Virginia, Tennessee, and New York. Differences in exemptions of business purchases occur more frequently. Such exceptions increase retailer costs of administering the tax and lead to compliance problems.

Tax Overlapping

In states where more than one type of local government is allowed to use a local sales tax, there is a potential for tax overlapping, or taxation of the same transactions by multiple jurisdictions. That is, a taxpayer could be paying sales tax simultaneously to a city, a county, a school district, and a transit district, all encompassing that person's residence and/or shopping area. Tax overlapping is a problem because it can result in a high total sales tax rate and can cause significant distortion of business location and consumer shopping decisions.³⁹ Except in Alaska, all local sales taxes also overlap a state sales tax; however, state-local overlap is a less serious problem than overlapping among local jurisdictions because there is less opportunity to avoid the overlap by shopping elsewhere, unless a border state is nearby and offers lower combined rates.

Twenty states permit both municipalities and counties to use the local sales tax, and in Louisiana, the tax is available to cities, parishes, and school districts. Usually, the problem of tax overlapping arises for counties and the cities they contain. Where transit districts use the sales tax, the rates are usually quite low (see Table 5), and the tax is added to other local sales taxes.

States use a variety of coordination methods to address the problem of sales tax overlapping. As shown in Table 6 (page 30), these methods include assigning sales tax authority exclusively to one type of local jurisdiction, applying the county tax only outside city limits, crediting the city tax against the county tax, and setting a maximum combined local sales tax rate. In addition, some cities and counties administer their local sales taxes cooperatively to reduce the problem of overlap.

Each method offers advantages and drawbacks. For example, three methods—the local credits approach, joint city-county administration, and applying the county tax only outside city limits—ensure that city retailers do not have to compete with sellers just outside the city limits with lower tax rates. Maximum combined local rates leave some overlapping, but limit the combined burden and tend to reduce the difference in rates between the municipality and its surrounding areas.⁴⁰

Locational Effects and the Border Issue

The response of consumer purchases to increases in the sales tax rate or to tax differentials (in economic terms, price elasticity) is important in determining whether to use a sales tax and what rate to set. Several studies suggest

that local sales taxes affect the location of retail activity and the decisions by consumers about where to shop, but are less likely to influence the location of non-retail business or residential choice.

Fox found that a tax rate differential did reduce sales and employment for retailers in three Tennessee border cities (Clarksville, Chattanooga, and Tri-Cities along the Tennessee/Virginia border) that were competing with retailers in adjacent states with lower sales tax rates.⁴¹ Mikesell, in a 1970 study, found that the effect of the sales tax on retail sales was significant; a 1 percentage point increase in the rate lowered per capita retail sales by amounts ranging from 1.69 percent to 10.97 percent.⁴² Of the various local taxes—property, income, and general sales—he found that the border effects were largest for the sales tax. A more recent study was done for retail grocery sales in border counties of West Virginia by Walsh and Jones. West Virginia was a particularly good case study during the period 1979-84 because it borders five other states, none of which changed their tax rates during 1980-82, when West Virginia cut its sales tax rate from 3 percent to 1 percent. The study found that a 1 percentage point reduction in the sales tax rate stimulated sales in border counties by about 5.9 percent.⁴³

Due and Mikesell summarize a number of studies of the border city problem and draw the following conclusions:

1. The extent of the border city problem has been reduced by the spread of the sales tax to almost all states. . . . Any state, however, that raises its sales tax rate can still expect some influence on sales. . . . The magnitude of the problem depends on the border situation of the state.
2. For states, the problem is aggravated when a substantial population is near the border, and the principal shopping center for the area is across the state line in the lower tax area. . . .
3. For cities, strong empirical evidence shows that a rate differential causes significantly lower per capita sales. . . . This evidence speaks strongly for the use of county-wide taxes when sales loss is feared.
4. The problem for states reaches its extreme form where a city straddles the border and part of its business district is in each state. Not only can sales loss be substantial, but tax administrators, retailers, and consumers face difficult problems in the collection and enforcement of sales taxes on either side of the border.⁴⁴

In an unusually strong response to an interstate border problem, Washington lowered the state sales tax rate in those counties bordering Oregon (a state with no general sales tax), until the practice was found unconstitutional. The limited use of local sales taxes in the Northeast may also reflect the relatively short driving distances to retail centers across state lines.

The border problem can be mitigated not only by limiting rate differentials with respect to adjacent communities, but also by any special advantages the taxing location may offer. Tourist areas, concentrations of shopping facilities, or other special locational advantages may be sufficient to allow a munici

Table 6
Tax Coordination Methods Used to Address Sales Tax Overlapping

State	Exclusive Authority			Overlap				
	Municipalities Only	Counties Only	Other Nonoverlapping Arrangements	No Method	County Tax Applies Only Outside City	City Credit Against County Tax	Maximum Combined Rate	Cooperative City-County Administration
Alabama				X				
Alaska							X	X
Arizona				X				
Arkansas				X				
California						X		
Colorado							X	
Florida		X						
Georgia			X ¹	X ²				
Illinois			X ³	X ⁴	X			
Iowa			X ⁵					
Kansas							X ⁶	
Louisiana							X	X ⁷
Minnesota	X							
Missouri				X ⁸				
Nebraska	X							
Nevada		X						
New Mexico					X ⁹			
New York							X ¹⁰	
North Carolina		X						
North Dakota	X							

Ohio		X		X ¹¹	
Oklahoma				X	
South Dakota	X				
Tennessee					X ¹²
Texas				X ¹³	
Utah					X
Virginia			X ¹⁴		
Washington					X
Wisconsin		X			X ¹⁵
Wyoming		X			

¹ Joint city-county "special districts."

² Metropolitan Atlanta Regional Transit Authority tax.

³ Regular state-administered tax.

⁴ County supplemental and locally administered tax.

⁵ The election to impose a tax is countywide, but the tax applies only in the cities and in the unincorporated areas of the county where a majority vote for imposition is received.

⁶ County precedence.

⁷ Several parishes do not apply their sales tax within cities with sales taxes.

⁸ Except in St. Louis County, where the county tax supersedes all city taxes.

⁹ Part of county tax does not apply in city.

¹⁰ City may preempt part of rate, but usually negotiates share with county.

¹¹ Transit authorities, which do not coincide with county boundaries.

¹² County precedence.

¹³ Higher rate option for counties only if they contain no incorporated city or town.

¹⁴ Independent cities and counties do not overlap.

¹⁵ When both city and county adopt tax, city and county rates are specified.

Sources: John Due and John Mikesell, *Sales Taxation: State and Local Structure and Administration* (Baltimore: Johns Hopkins University Press, 1983), Ch. 10; and National League of Cities, *Local Government Tax Authority and Use* (Washington, DC: NLC, 1987).

pality to charge a higher local sales tax and still not suffer serious loss of retail sales or retail firms.

Tax Situs and Tax Avoidance

The opportunity to avoid the sales tax depends in part on the choice of tax situs—whether the tax will be levied at the point of sale or point of delivery. This decision is even more critical for local sales taxes than for state sales taxes.

The state retail sales tax in the United States is primarily a destination principle tax; that is, the tax is charged to the buyer where the good or service is delivered, rather than at the point of origin or sale. For most purchases subject to the state sales tax, the distinction is not important because the point of origin and point of delivery are within the same state. However, there are two broad categories of transactions or buyers for which the distinction is important: mail order purchases and tourist/business travelers. Mail order purchases often escape taxation both at the point of origin and at the point of delivery, an issue addressed below. More significant for the local sales tax are the purchases of the tourist or business traveler, who pays the sales tax at the point of sale unless delivery is arranged to a home address. Both tourists and business travelers make many purchases for immediate use, such as meals, clothing, and toiletries. These expenditures can be a significant source of state and local sales tax revenue, especially in major tourism and business centers.

A 1983 study by Mutti and Morgan found that 16 states were net exporters of what they refer to as household type taxes (principally general sales and excise taxes). In other words, these states derived a significant amount of tax revenue from nonresidents. Most of these were states with substantial tourist activity. Of these 16, Georgia, Colorado, and Alaska were the only ones that also rely heavily on local sales taxes.⁴⁵ For these three states, exporting local sales taxes through tourism has probably been a significant local revenue enhancement.

Even in states that do little exporting of sales taxes to other states, the potential for exporting taxes from one jurisdiction to another within a state can be quite large. One might expect that the net exporters of sales taxes would be the larger urban retail centers or resort areas. However, a 1976 study by Stocker found that, at least within the very largest SMSAs, retail sales in the central cities are often less than proportional to their share of the SMSA's population or income. In recent decades, retail trade has shifted to some extent to the suburbs, reducing the ability of very large cities to use the local sales tax to draw in revenue from the surrounding area.⁴⁶

The choice of vendor location rather than delivery location as the tax situs enhances the ability of local governments to export local sales taxes both to residents of surrounding jurisdictions and to out-of-state buyers. Sixteen of the 30 states with local sales taxes use vendor location rather than delivery site as the basis for collecting the tax.⁴⁷ In the other states, the destination principle applies, and the buyer is liable for local use tax in the city or county of residence. Since the local use tax (see below) is even more difficult and costly than the state use tax to collect and enforce, this choice is an expensive one in terms of both lost revenue and administrative costs.

The choice of vendor location also makes the tax much more attractive to large retail centers that depend on tourists, commuters, and business visitors to pay a large part of the tax. To the extent that these consumers are paying for benefits received from the retail center, this choice may be considered equitable. To the extent that the sales tax is used to finance services that primarily benefit residents, the point of delivery (destination or residence) may be considered more appropriate.

While vendor location as the situs for local sales taxes increases potential tax revenues and allows central cities to tap their surrounding suburbs, it is not without problems. Monitoring of evasion is difficult and expensive, and enforcement costs can be very high. The most dramatic stories of evasion of local sales taxes come from New York City, a major retail center where the local sales tax is higher than the state sales tax. Recent stepped-up enforcement efforts have uncovered substantial evasion and increased revenues considerably.⁴⁸

A related issue is the state and local taxation of interstate mail order sales. Since the tax situs for state sales taxes is generally based on the place of delivery rather than vendor location, most often no tax is collected from mail order sales in the state of origin. At present, states are unable to collect the use tax on such purchases unless the vendor meets a nexus test, i.e., unless the firm has some clear economic link to the destination state such as an office, warehouse, or retail outlet. Proposed legislation now pending in the Congress would remove this impediment. Local government officials have urged strongly that such legislation include enforcement of local sales and use taxes, but this proposal would considerably increase compliance costs and has delayed passage of legislation. This issue is addressed in more detail below.

The Local Use Tax

One of the most controversial issues in local sales taxation is whether local governments may charge a use tax. The state use tax, which emerged shortly after states began enacting sales taxes in the 1930s, is levied on purchases made in other states and brought into the state by the final purchaser. Since state sales taxes are largely destination principle taxes, buyers typically are excused from the tax if they are from another state and are having the purchase delivered to that state. (In most cases, if the sales tax is collected by the state of origin, it is credited against use tax liability in the destination state.) Absent a use tax, such purchases would escape sales taxation in both the state of purchase and the state of destination. The state use tax is designed to close that loophole, and to provide a deterrent to shopping in border cities or by mail in order to escape sales tax.

Local use taxes are based on the same rationale as state use taxes. They collect tax revenue on purchases brought into the jurisdiction that would otherwise escape taxation. The local use tax is not an issue in states where tax liability is based on vendor location rather than delivery site. In these states, whether the buyer is an in-state resident or an out-of-state resident, the local sales tax is collected where the sale occurs (i.e., on the origin principle). Twelve states, however, award the right to collect the tax on the destination principle—that is, to the local jurisdiction in which delivery occurs. These

states are Alabama, Colorado, Georgia, Iowa, Louisiana, Minnesota, Nebraska, New York, North Carolina, South Dakota, Wisconsin, and Wyoming. This list includes a few states that are major users of the local sales tax, and in these states the local use tax is an important issue.⁴⁹

States have three options for addressing local use taxes: to forbid them, to allow use taxes on purchases made out of state but not elsewhere within the state, or to allow taxation of all purchases that residents make outside the local taxing jurisdiction. A National League of Cities (NLC) study indicates that a majority of states with local sales taxes allow their major taxing jurisdictions, such as counties and municipalities, to impose local use taxes; in some states, authorization to employ a local use tax may vary by type of jurisdiction.⁵⁰ Among states that authorize the local use tax, it is more common to tax only purchases made out of state (Wisconsin is an example), but a few cities require payment of use taxes on in-state purchases made outside the taxing city.

The use tax, at both the state and local levels, is difficult to enforce. Due and Mikesell describe the use tax as “. . . the weak link in state sales tax administration” because of such enforcement problems.⁵¹ Local governments face the same kinds of problems as states in trying to collect use taxes; in fact, the problems are intensified by the limited local geographic reach. However, enforcement is generally quite easy for automobiles because they must be registered in the state in which they will be used. For other “big ticket” items, such as boats, computers, and furs, some states have developed cooperative information exchanges to facilitate collection. With state administration of the local sales tax, it is not difficult for states to extend their use tax enforcement to include use tax due to the local government.

State v. Local Administration

Another important issue in state authorizing legislation is whether the local sales tax should be administered by the state or by a local agency. The ACIR's 1974 report strongly supported state administration. Due and Mikesell also argue that, “Local administration has created substantial problems in virtually every application.”⁵² They point out that state administration facilitates collection of local use taxes (where applicable) on interstate transactions, simplifies coordination of taxes in overlapping jurisdictions, and reduces the need to provide compensation to vendors for compliance costs.⁵³ Critics of local collection also argue that it is likely to result in higher costs, including both administrative cost to the local government and compliance costs for the retailer, who must duplicate filing and recordkeeping.⁵⁴ Since local sales taxes are believed to adversely affect business location within taxing jurisdictions, any additional costs associated with local administration may further encourage retailers to locate outside the borders of taxing cities or counties.

Some states require state administration of the local sales tax; others offer central administration as a service for which local governments may opt to contract, while still others leave administration to the local agency. As shown in Table 7 (page 35), 22 states have state administration only, five states have mixed state-local administration, and three states have local administration

Table 7
Administration of Local Sales Tax in 1988

States with Local Sales Tax	State Administration		Local Administration	Shared Administration	Charge for State Collection
	Required	Optional			
Alabama				X	cost ¹
Alaska			X		n.a.
Arizona				X	none
Arkansas	X				3.0%
California		X			0.82%
Colorado				X	none
Florida	X				cost
Georgia	X				1.0%
Illinois				X	2.0%
Iowa		X			none
Kansas		X			none
Louisiana			X		n.a.
Minnesota				X	cost
Missouri	X				1.0%
Nebraska	X				3.0%
Nevada		X			1.0%
New Mexico	X				2.0% ²
New York	X				cost
North Carolina		X			cost
North Dakota			X		n.a.
Ohio		X			1.0%
Oklahoma		X			1.0% ³
South Dakota	X				1.8%; 1.25% ⁴
Tennessee		X			cost
Texas	X				2.0%
Utah		X			cost to 2.5%
Virginia	X				\$1.4 million ⁵
Washington	X				none
Wisconsin		X			3.0%
Wyoming	X				1.0%

n.a. — not applicable.

¹ Cities and newer county adoptions charged on number of accounts or fixed percentages (5% for smaller units, 10% for larger). Others charged percentage of state collection cost.

² In jurisdictions where rate is greater than .5%.

³ For municipalities, charge is 1% with 3 or 4% rate, 1.5% with 2% rate, and 1.75% with 1% rate.

⁴ 1.8% if tax does not conform to state law; 1.25% if tax does conform. There is also a \$325 annual fee, a start-up charge of \$350 + \$1.50 per licensee, and a charge of \$350 + \$.90 per licensee for amendments.

⁵ In 1988, Virginia collected \$1.4 million to cover the costs of its audit program.

Sources: National League of Cities, *Local Government Tax Authority and Use* (Washington, DC: NLC, 1987); Commerce Clearing House, Inc., *State Tax Reporter*, various issues; and unpublished survey data collected by the Federation of Tax Administrators, November 1988.

only. Of the states that offer central administration, five (Arizona, Colorado, Iowa, Kansas, and Washington) provide collection at no charge to the local government; the remaining states charge on the basis of cost, a percentage of the revenue collected, or cost up to a maximum. Rates charged for state collection services range from around 1 to 3 percent of revenues.⁵⁵

Illinois is an example of a state where administrative responsibility for the sales tax is shared among the state and the local governments. Due comments that the complex system in Illinois manages to incorporate “the worst of all evils: state administered local sales taxes, and, in addition, locally administered sales tax (on top of the state administered levies), with frequently different bases than the state levy.”⁵⁶

Some cities (about 9 percent of cities in Alabama and 14 percent in Arizona) have chosen to collect their own tax where that option is available. Tax administrators in some cities argue that they can do a better job of identifying retailers and performing audits. In other cases, local administration allows a locality to make use of a tax base that is different from that of the state, or facilitates collection of local use taxes. Although state collection is much easier when the local base conforms to the state base, local administration allows local sales and use taxes to be designed to meet local needs and preferences.

Past ACIR Recommendations

In its 1974 study, *Local Revenue Diversification: Income, Sales Taxes & User Charges*, ACIR addressed a number of the design issues discussed above. The recommendations included a set of safeguards to be observed in state authorizing legislation for local sales taxes:

Safeguard 1: Uniform Tax Base

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

Safeguard 2: State Administration

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

Safeguard 3: Universal or Widespread Coverage

Encourage universal or widespread coverage by (1) mandating a minimum local levy and permitting counties and those cities with populations of at least 25,000 to choose a rate above this subject to a specified maximum, or by (2) giving first option to adopt the tax to the local government of widest jurisdictional reach, with sharing provisions for municipal governments. The authority to adopt local sales and income taxes should also be extended to cities with populations of at least 25,000 if the larger unit of general government does not adopt the tax.

Safeguard 4: Origin Tax Situs

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

Safeguard 5: Constrained Rate Option

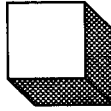
Permit local flexibility by specifying a range of tax rates that general purpose local governments may impose.

Safeguard 6: State Equalization

Minimize local fiscal disparities in those states characterized by a high degree of local fiscal responsibility and a fragmented local government structure by adopting an equalization formula for the distribution of local nonproperty tax revenues among constituent units within the local taxing authority of widest jurisdictional reach and adopting new programs or using existing state programs of general support to offset fiscal disparities among local taxing authorities with the widest jurisdictional reach.⁵⁷

The record of the states in observing these guidelines is mixed. The majority of the 30 states with local sales taxes have them administered by the state, with a uniform tax base (Safeguards #1 and #2). While 12 states use destination rather than origin as the tax situs, most conform generally to Safeguard #4. Most states offer a constrained rate option (Safeguard #5), but only 11 have universal coverage for a particular type of local government (all cities or all counties), recommended in Safeguard #3.

The one issue raised by ACIR that has been largely ignored in designing local nonproperty taxes is the concern for horizontal fiscal equalization between tax-rich and tax-poor local jurisdictions. In general, states have preferred to address equalization by other means in order to provide some local autonomy and “ownership” of local sales (and income) taxes.



Current Issues

Interest in the local sales tax remains high. Several states are contemplating adoption of local sales taxes at this time. The tax is firmly established as an important local revenue source, and the number of jurisdictions using the tax shows steady growth from year to year.

Although the federal income tax reform of 1986 removed federal income tax deductibility from state and local sales taxes, no states seem to have retreated from the tax because of that change. The local sales tax has also been a focal point in the debate over taxation of interstate mail order sales. Base erosion and base broadening continue to be serious questions; one recent attempt at base broadening, extending the tax to advertising and other services in Florida, met with considerable opposition and was eventually rescinded. Each of these issues is discussed below.

Loss of Income Tax Deductibility

The elimination of the deductibility of state and local sales and use taxes was the subject of heated debate prior to the passage of the *Tax Reform Act of 1986*. It was argued that this loss of deductibility would encourage state and local governments to rely more heavily on income and property taxes, both of which are still deductible. However, the tax law also considerably reduced the percentage of the population that itemizes deductions for two reasons: a higher standard deduction and loss of other deductions, so that for most families these deductions are less than the standard deduction. Lower tax rates for most taxpayers also reduced the value of any deduction and thus reduced pressure to shift from nondeductible to deductible types of state and local taxes. The full impact of the myriad changes in the federal income tax is yet to be felt, in particular, its effect on the spread of local sales taxes.

Local Sales and Use Taxes and Interstate Mail Order Sales

Federal legislation introduced in 1987 and 1988 proposed to remove legal impediments that have prevented states from enforcing the use tax on a large portion of interstate mail order purchases. Most sales taxes are enforced through vendor collection, even though in most cases the legal liability (and the economic incidence) is on the buyer. While state and local governments can easily compel compliance for vendors within their local jurisdictions, it is much harder to require cooperation from outside vendors. States have been able to require mail order firms that meet a "nexus" test to collect and remit

the tax. The nexus test is a legal test, applied in a landmark 1967 Supreme Court decision (*National Bellas Hess v. Illinois Department of Revenue*) to determine whether an out-of-state firm was liable for collecting a state's use tax. Nexus measures the extent of the firm's economic links to the state in the form of facilities, regular sales calls, and similar criteria.⁵⁸

Local government representatives have insisted that federal legislation providing for collection of taxes on out-of-state mail order sales include local as well as state use taxes in destinations with local sales and use taxes. This dispute between state and local officials held up congressional consideration of legislation on mail order sales during 1988, and states and localities attempted to work out a mutually acceptable solution. While it is easier to accommodate a collection requirement in states like California and Virginia, which have uniform and universal local taxes, it is much more difficult in states where the local tax is not universal, not at uniform rates, or not even on the same base. It is also more difficult to comply with and to administer an interstate use tax where the local sales tax is locally administered. On the other hand, the revenue potential, especially for large cities with high rates, is substantial.

States and local governments have also been seeking a solution to the mail order question through the courts. A 1980 New York case, *Aldens, Inc. v. James H. Tully, Jr. et al.* upheld the right of local jurisdictions to collect use taxes on interstate mail order sales when the state expected to collect them in the future, with or without passage of the proposed federal legislation.⁵⁹

Base Erosion and Base Broadening

During the 1970s, the major threat to the sales tax, state or local, seemed to be the proliferation of exemptions and the resulting erosion of the tax base. Particularly popular during that period were exemptions for utility sales, food, and prescription drugs. By the mid-1980s, the trend toward adding exemptions had slackened. In 1986, Florida, which has a constitutional prohibition on an income tax, sought additional revenue by broadening rather than narrowing the sales tax base, through increased taxation of services. The state was not a pioneer in this respect: Hawaii and New Mexico, among other states, tax most consumer services. Florida, however, included a considerable number of business services in its expanded tax base, including legal services and interstate sales of advertising services. There were immediate legal and legislative challenges to the new tax law, and it was finally repealed. Other states have observed the pitfalls of Florida's experience as they consider broadening their own bases.

Where the local tax base conforms to the state base, state expansion into more service taxation will increase local revenues as well. In general, the taxation of services makes the sales tax less regressive, but it also increases administrative and compliance costs because of the large number of small service providers. It will also create new border problems for localities that are service centers rather than retail sales centers. In states where the base is set

locally, local governments will have to consider whether to follow the state's lead, or even jump the gun, in expanding taxation of services.

Summary and Conclusions

The local sales tax has evolved over the last 50 years from an emergency measure in a few local areas to an established component of local revenues in more than half of the states, and a major revenue producer in nearly one-third of them. Its use can be expected to expand in states where it is authorized, and it may be adopted in the next few years in other states. As additional states contemplate authorizing the tax, and as local governments where the tax is authorized consider whether to adopt it, they must address the design problems and weigh the advantages and drawbacks.

For states, authorizing a local sales tax may reduce pressures on the state for more intergovernmental aid and give local government more autonomy in raising revenue. In weighing the various ways to reduce aid and increase autonomy, this tax is attractive as a complement to the property tax that may be acceptable in the eyes of the public and sensitive to growth and inflation. On the other hand, a local sales tax not only provides little or no fiscal equalization among localities—an important issue in many states—but may also create resistance to any future increases in the state sales tax rate.

If a state decides to authorize the tax, legislators must weigh carefully the balance between state and local uniformity of rates and bases, which generally leads to fewer location problems and lower administrative and compliance costs, and greater fiscal independence for local governments. For local jurisdictions that already use the sales tax, there are important design issues to consider in refining and improving its operation, such as the costs and benefits of local administration, the impact of higher rates on revenues and on the location of retail firms, and the opportunities to export the tax. For local jurisdictions that do not use this tax, it deserves consideration as one candidate for revenue diversification.

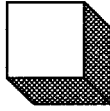
NOTES—

- ¹ The Census Bureau defines general sales or gross receipts taxes as "Taxes, including 'licenses' at more than nominal rates, based on volume or value of transfers of goods or services; upon gross receipts, or upon gross income; and related taxes based upon use, storage, production (other than severance of natural resources), importation, or consumption of goods. Dealer discounts of 'commissions' allowed to merchants for collection of taxes from consumers are excluded." Local general sales taxes include use taxes, but do not include excise taxes or surtaxes on accommodations, resorts, or other excise-type taxes, which are included in some other tabulations of sales tax revenues.
- ² U.S. Department of Commerce, Bureau of the Census (Census Bureau), *Government Finances in 1986-87* (Washington, DC: Census Bureau, November 1988).
- ³ _____, *City Government Finances in 1986-87* (Washington, DC: Census Bureau, March 1989). Local own-source revenue is exclusive of federal and state aid, but includes user charges, fees, interest, etc. Local tax revenues refers only to revenues raised through local taxes, not any other means.
- ⁴ U.S. Advisory Commission on Intergovernmental Relations (ACIR), *Local Nonproperty Taxes and the Coordinating Role of the State* (Washington, DC: ACIR, 1961).
- ⁵ _____, *Local Revenue Diversification: Income, Sales Taxes and User Charges* (Washington, DC: ACIR, 1974), pp. 2-3.

- ⁶ James D. Rodgers, "Sales Taxes, Income Taxes, and Other Non-Property Revenues," in J. Richard Aronson and Eli Schwartz, eds., *Management Policies in Local Government Finance*, Third Edition (Washington, DC: International City Management Association, 1983), p. 229.
- ⁷ David Merriman, *The Control of Municipal Budgets: Toward the Effective Design of Tax and Expenditure Limitations* (New York: Quorum Books, 1987), pp. 20-23.
- ⁸ Although Kentucky authorizes a local sales tax for transit authorities (and is included in the total of 31 states authorizing local use of the tax), no jurisdiction uses this tax at present.
- ⁹ Idaho authorizes resort cities to use a tax that is similar to taxes on transient lodgings used in many states, and therefore classified in this study as a selective sales tax. For a description of authorization and referenda requirements, see National League of Cities, *Local Government Tax Authority and Use*, Table III-4a.
- ¹⁰ For a description of key features of local sales taxes, see ACIR, *Significant Features of Fiscal Federalism* (Washington, DC: ACIR, 1986) and Rodgers, pp. 229-259. Current information on local sales taxes is available in Commerce Clearing House, *State Tax Reporter* (annual).
- ¹¹ A comparison of the ACIR count of the number of jurisdictions with sales taxes and those made by the Tax Foundation, the National League of Cities, and firms providing sales tax information for the use of retailers shipping across state lines shows considerable variation in the numbers reported. Some of this variation may result from a difference in the purposes for which the tabulations are made; retailers are interested in identifying which jurisdictions collect the taxes, not necessarily the ones that are the ultimate recipients of the tax revenue, while the ACIR count attempts to identify the ultimate recipient of the tax rather than the one that serves as collection agent. In addition, some discrepancies arise from differences in the time periods at which the counts are made. Regardless of which tabulation is used, all of them lead the observer to conclude that the number of jurisdictions is steadily increasing.
- ¹² ACIR, *Local Revenue Diversification: Local Income Taxes* (Washington, DC: ACIR, 1988).
- ¹³ For a brief review of the issues and the literature relating to border effects and consumption taxes, see Ronald C. Fisher, *State and Local Public Finance* (Glenview, Illinois: Scott, Foresman, and Company, 1988), pp. 179-186.
- ¹⁴ Census Bureau, *Government Finances in 1986-87*.
- ¹⁵ Among the states, Nevada provides the clearest example of the use of a local (statewide) sales tax intended to provide indirect property tax relief. For a discussion and evaluation, see Robert D. Ebel, ed., *A Fiscal Agenda for Nevada* (Reno: University of Nevada Press, 1989).
- ¹⁶ This tax contains a second unique feature as well: a maximum duration of 15 years. The rate—either 1/2 cent or 1 cent—and the duration is decided by referendum.
- ¹⁷ John Due and John Mikesell, *Sales Taxation: State and Local Structure and Administration* (Baltimore: Johns Hopkins University Press, 1983), pp. 66-69.
- ¹⁸ *Ibid.* For a detailed discussion of the methodology for estimating the exporting of a sales tax in a tourist industry, see Ebel, Chapters 6 and 16.
- ¹⁹ ACIR, *Local Revenue Diversification*, p. 3.
- ²⁰ Rodgers, p. 233.
- ²¹ William F. Fox and Charles Campbell, "Stability of the State Sales Tax Income Elasticity," *National Tax Journal* 37 (June 1984): 201-212.
- ²² Bradford Case and Robert D. Ebel, "Using State Consumer Tax Credits for Achieving Equity," *National Tax Journal* 42 (September 1989).
- ²³ ACIR, *Local Revenue Diversification*, pp. 4, 41-46.
- ²⁴ Due and Mikesell, pp. 323-7.
- ²⁵ Peat Marwick Mitchell and Co., "Report to the American Retail Federation on Costs to Retailers of Sales and Use Tax Compliance." 1982 (mimeo).
- ²⁶ Peat Marwick Main, "A Comparative Analysis of Sales Tax Compliance Costs for Small Business," study performed for the Small Business Administration. 1985 (unpublished).

- ²⁷ ACIR, *Changing Public Attitudes on Governments and Taxes* (Washington, DC: ACIR, 1987), p. 6.
- ²⁸ _____, *Changing Public Attitudes on Governments and Taxes*, 1983, pp. 1-2.
- ²⁹ _____, *Changing Public Attitudes on Governments and Taxes*, 1989, p. 18.
- ³⁰ 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): 103-114; and Walter S. Misiolek and D. Grady Perdue, "The Portfolio Approach to State and Local Tax Structures," *National Tax Journal* 40 (March 1987): 111-114.
- ³¹ See Holley Ulbrich, Rodney Mabry, and John Warner, "Does the Local Sales Tax Provide Property Tax Relief?" presented at the Western Economic Association meetings, June 1989, Lake Tahoe, NV.
- ³² 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): 205-211.
- ³³ Vincent Ostrom et al. note that there is a poor match between benefits and costs for the sales tax, but argue that urban retail centers often generate more revenues from the sales tax than they incur costs from nonresidents. Thus, they are able to export the tax to a large extent. See Vincent Ostrom, Robert Bish, and Elinor Ostrom, *Local Government in the United States* (San Francisco: Institute for Contemporary Studies, 1988), pp. 206-207, for a review of conflicting evidence on this point.
- ³⁴ David L. King, *Fiscal Tiers: The Economics of Multi-Level Government* (Winchester, Massachusetts: Allen and Unwin, 1984), Chapter 6.
- ³⁵ 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; and Kenneth V. Green, William B. Neenan, and Claudia D. Scott, *Fiscal Interactions in a Metropolitan Area* (Lexington, Massachusetts: D.C. Heath, Lexington Books, 1974).
- ³⁶ See, for example, William J. Stober, "A Study of State Tax Incidences—The Kentucky Case," *Revenue Administration*, 1983, pp. 191-197, which found that the net burden of the Kentucky sales and use tax (plus the motor vehicle tax) ranged from 27.1% of income for incomes less than \$3,000, to 5.3% for incomes of \$5,000-6,000, 4.1% for incomes of \$10,000, and 1.1% of incomes above \$35,000.
- ³⁷ See, for example, ACIR, *Local Revenue Diversification*, and Craig E. Reese, "Local Sales Taxation—Current Practices and Further Prospects," *Proceedings of the Sixty-Ninth Annual Conference* (Columbus, Ohio: National Tax Association, 1977), p. 22.
- ³⁸ Nevada's 5.75 percent rate is a state levied, statewide rate. The state constitution requires that 2 percent of the collections go to the state. The remainder (3.75 percent) is earmarked for local government use, and is distributed by a legislative formula.
- ³⁹ Tax overlapping can also occur with property taxes levied by multiple local jurisdictions. While there is less opportunity to avoid this overlap than a sales tax overlap, overlapping property taxes may also affect economic decisions by being capitalized into real estate prices.
- ⁴⁰ John H. Bowman and John L. Mikesell, *Local Government Tax Authority and Use*, State-Local Backgrounder Series (Washington, D.C.: National League of Cities, 1987), p. 62.
- ⁴¹ William F. Fox, "Tax Structure and the Location of Economic Activity along State Borders," *National Tax Journal* 39 (December 1986): 387-402.
- ⁴² John L. Mikesell, "Central Cities and Sales Tax Differentials: The Border City Problem," *National Tax Journal* 23 (June 1970): 206-214.

- ⁴³Michael D. Walsh and Jonathan D. Jones, "More Evidence on the Border Tax Effect: The Case of West Virginia, 1979-1984," *National Tax Journal* 41 (June 1988): 261-266.
- ⁴⁴Due and Mikesell, pp. 316-317.
- ⁴⁵John H. Mutti and William E. Morgan, "The Exportation of State and Local Taxes in a Multilateral Framework: The Case of Household-Type Taxes," *National Tax Journal* 36 (December 1983): 459-476.
- ⁴⁶Frederick D. Stocker, "Diversification of the Local Revenue System: Income and Sales Taxes, User Charges, Federal Grants," *National Tax Journal* 29 (September 1976): 312-321.
- ⁴⁷National League of Cities, *Local Government Tax Authority and Use*, Table III-4c. Two states (California and Illinois) use vendor location for cities and counties, but delivery for other jurisdictions using the local sales tax.
- ⁴⁸Robert Wood, "A 'Big Ticket Item' Enforcement Program," *Revenue Administration*, 1985, pp. 32-35. Interstate agreements are also used for enforcement. For a description of one such agreement, see John R. Baldwin, "The Use of Interstate Agreements in Sales Tax Enforcement," *Revenue Administration*, 1985, pp. 35-38.
- ⁴⁹Florida's new local sales tax offers a unique approach to local tax collection. Although Florida basically employs vendor location, sales are exempt if they are being delivered into a county without the local option sales tax. If delivery is made into a county with the local option sales tax, then the vendor is permitted to collect the tax on behalf of the county of origin.
- ⁵⁰National League of Cities, *Local Government Tax Authority and Use*.
- ⁵¹Due and Mikesell, p. 264.
- ⁵²Ibid., p. 280.
- ⁵³Ibid., pp. 313-314.
- ⁵⁴Rodgers, p. 239.
- ⁵⁵National League of Cities, *Local Government Tax Authority and Use*, Table II-4b. Rodgers notes that Due and Mikesell found the average cost of state sales tax administration to be about 0.73 percent of revenues. Thus, state charges may be too high relative to actual cost.
- ⁵⁶Letter from John Due to the ACIR, July 1, 1988.
- ⁵⁷ACIR, *Local Revenue Diversification*.
- ⁵⁸For a complete discussion of the issues involved in taxation of interstate mail order sales, see ACIR, *State and Local Taxation of Out-of-State Mail Order Sales* (Washington, DC: 1986).
- ⁵⁹183 N.Y.L.I. 61 (March 30, 1980). This case is discussed in David L. Welsh, "Sales and Use Tax Update," *Revenue Administration*, 1981, pp. 142-143.



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As a continuing body, the Commission addresses specific issues and problems, the resolution of which would produce improved cooperation among the levels of government and more effective functioning of the federal system. In addition to dealing with important functional and policy relationships among the various governments, the Commission extensively studies critical governmental finance issues. One of the long-range efforts of the Commission has been to seek ways to improve federal, state, and local governmental practices and policies to achieve equitable allocation of resources and increased efficiency and equity.

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