

Proceedings of the 2009 Land Policy Conference



MUNICIPAL REVENUES AND LAND POLICIES



Edited by Gregory K. Ingram and Yu-Hung Hong

Budget Appropriation Added by N.J.S 40A-4-87	16,441,446 00	1,806,568 00	Utility
Emergency Appropriations	2,000 00		
Other Expenses	2,330,000 00	1,806,568 00	
Reserved	15,810,815 00	1,770,170 00	

Municipal Revenues and Land Policies

Edited by

Gregory K. Ingram and Yu-Hung Hong

 LINCOLN INSTITUTE
OF LAND POLICY
CAMBRIDGE, MASSACHUSETTS

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Library of Congress Cataloging-in-Publication Data

Municipal revenues and land policies /
edited by Gregory K. Ingram and Yu-Hung Hong.
p. cm.

Includes bibliographical references and index.

ISBN 978-1-55844-208-5 (alk. paper)

1. Municipal finance—United States. 2. Land use—Government policy—United States.
I. Ingram, Gregory K. II. Hong, Yu-Hung. III. Lincoln Institute of Land Policy.

HJ9141.M86 2010

336.2'014—dc22 2010006976

Designed by Vern Associates

Composed in Sabon by Achorn International in Bolton, Massachusetts.

Printed and bound by Puritan Press Inc., in Hollis, New Hampshire.

 The paper is Rolland Enviro100, an acid-free, 100 percent PCW recycled sheet.

MANUFACTURED IN THE UNITED STATES OF AMERICA

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6

The Contribution of Local Sales and Income Taxes to Fiscal Autonomy

John L. Mikesell

Locally enacted retail sales and income taxes provide American local government with revenue diversification. Because of their broad base, these taxes have considerable revenue potential at relatively low rates and can provide an alternative to the property tax in revenue systems. Although revenue from these taxes is swamped by property tax collections in total, the national yield from sales and income taxes is around \$80 billion and, in a number of local governments around the United States, these broad nonproperty taxes provide a substantial share of revenue that localities raise on their own.¹ In a number of larger cities, the revenue from nonproperty taxes exceeds collections from the property tax, and in other localities, the property tax has been legally constrained so significantly that the only important source for budget increases is the local income or sales tax. Some large cities in which nonproperty tax revenues exceed property tax revenues include, for example, Detroit (income tax 1.12 times property tax), Columbus (income tax 10 times property tax), Phoenix (sales tax

Melinda Brooks and Shukhrukh Kurbanov assisted with this research. The Governments Division of the U.S. Census Bureau graciously provided unpublished data and ran special data tabulations, without which parts of this research would have been impossible. The author retains responsibility for any errors that might remain.

1. This analysis excludes selective sales taxes, like taxes on restaurant meals, transient lodgings, utilities, etc., that are levied in a number of states. It also excludes business and occupation taxes levied on employers and employees. It examines only local taxes that, at least in general, are comparable to the state retail sales and the federal income taxes in structure and logic. It also excludes taxes levied at the state level with revenue legally earmarked for local use, regardless of whether the revenue is returned to the location of collection or distributed according to some other formula. These are best examined as shared taxes, not local taxes.

4.5 times property tax), Denver (sales tax 2.8 times property tax), Philadelphia (income tax 2.8 times property tax), and New York City (sales and income tax combined 1.66 times property tax).² Of the twenty largest cities in the United States, only Milwaukee does not levy its own income or retail sales tax.³

As local governments work through their options for a revenue system able to support the demands for services for their citizenry, a renewed consideration of how local sales and income taxes might contribute to the solution is in order. If local governments are to retain the capacity to respond to the preferences of their citizens by adjusting the size of their budgets and the manner in which the cost of those budgets is distributed across private taxpayers, in other words, if they are to be something other than decentralized service units of their state governments, understanding the complete range of productive local tax options is useful. Analysis of large American counties shows that state-level reliance on local sales and income taxes that are 1 percentage point higher reduces the combined property tax burden relative to household income by 4 to 4.5 percentage points (Mikesell and Mullins 2009). The taxes not only provide greater expenditure options, but also facilitate relief from the property tax.

Broad sales and income taxes promise revenues outside the property tax system that are not characterized by the distortions, inequities, and inefficient collection that characterize narrower sources like small excises, licenses, and fees that states sometimes assign their localities, so they merit closer consideration for local revenue portfolios. However, the taxes must be considered within the limits of options the states provide. Not all states allow their localities to levy sales or income taxes, and not all types of local government in states providing the option are given this taxing authority.⁴ But where the option is provided, it may provide a significant alternative source for local finance.

An Overview of Local Sales and Income Taxes in the National Revenue System

Recent local revenue data show total local general sales tax collections of more than \$55 billion and local income tax collections of more than \$28 billion. How

2. Calculated from the most recent comprehensive annual financial report for each city.

3. Milwaukee County does levy a sales tax. Indianapolis does not directly levy an income tax, but Marion County, consolidated with Indianapolis through the Unigov structure—a group of overlapping special districts that is governed by a special council—does. Including Indianapolis on the list of cities levying an income tax isn't precisely right, but doing so probably causes less confusion than excluding it.

4. Because local governments are legally created by their states in the American system of government, they have only the powers explicitly granted them. Some authorizations are extremely broad (through home rule legislation), and some are narrow, but in both cases the authority flows from the state government. Local sales or income taxes may be levied only if allowed by the state.

ever, the importance of these nonproperty taxes varies considerably according to type of locality. Table 6.1 shows the extent to which counties, municipalities, special districts, and school districts rely on these taxes, providing data for fiscal years 1996–1997 and 2005–2006. Their reliance varies considerably by type of local government as well as by type of nonproperty tax, and this is important for understanding how the taxes fit into the national revenue structure. The table shows minimal change in the tax shares in the 1997–2006 period (mostly in regard to increased reliance on local sales tax by special districts and school districts and reduced reliance on local income taxes and local sales taxes by municipalities), so the following discussion will focus only on the later year.⁵

General purpose governments—counties and municipalities—collect a far greater share of total local income and sales taxes than do other localities. Municipalities are the heaviest users; more than three-quarters of all local income tax levies are for them, and almost 60 percent of all local general sales taxes are municipal. Special district and school district taxes constitute a much more modest share of the total, and there are no special district income taxes. While county taxes constitute more than one-third of local sales tax revenue, they collect only 16.5 percent of local income tax revenue.

As is often the case with subnational taxes, tax revenue is concentrated in a relatively small number of states. The five highest local sales tax revenue states (New York, California, Texas, Georgia, and Louisiana) accounted for 54.5 percent of total local sales tax revenue in fiscal year 2005–2006, and the top five highest local income tax revenue states (New York, Ohio, Maryland, Pennsylvania, and Kentucky) accounted for 93.1 percent of the total in that year (U.S. Census Bureau 2008a).⁶ This concentration is partly the result of the unequal distribution of tax base across the states, but not all states give localities these nonproperty tax options and, where the option is provided, their adoption among localities is not uniform. There are many states in which neither local tax is levied and in which levies are relatively unproductive. In sum, the local sales and income tax discussion must focus on a subset of the states, and much of the national yield is generated in a relatively small number of states.

There are significant differences across types of government in terms of the importance of local sales and income tax revenues in revenue systems.

- *Municipalities.* Local sales taxes are most important in the revenue systems of municipalities, yielding 14.67 percent of their tax revenue, 9.27 percent of their own-source general revenue, and 6.76 percent of their general revenue. Although local income taxes are less important to municipalities

5. The tabulations for tax collection by type of local government were done by the Public Finance Analysis Branch, Governments Division, U.S. Census Bureau, expressly at the request of this project.

6. These percentages exclude data for the District of Columbia.

Table 6.1

General Sales and Income Tax Revenue in Local Revenue Systems, Fiscal Years 1996–1997 and 2005–2006 (%)

	Share of All Local Sales Tax		Share of All Local Income Tax	
	FY 1996–1997	FY 2005–2006	FY 1996–1997	FY 2005–2006
Counties	39.24	36.52	12.86	15.01
Municipalities	52.41	49.61	82.15	79.52
Special districts	5.66	7.86	0.00	0.00
School districts	2.69	6.02	4.99	5.46
Share of Tax Revenue from				
	Sales Tax		Income Tax	
	FY 1996–1997	FY 2005–2006	FY 1996–1997	FY 2005–2006
Counties	18.09	17.08	3.26	3.57
Municipalities	17.42	14.67	17.22	11.95
Special districts	16.85	23.47	0.00	0.00
School districts	0.88	2.09	0.90	0.96
Share of Own-Source Revenue from				
	Sales Tax		Income Tax	
	FY 1996–1997	FY 2005–2006	FY 1996–1997	FY 2005–2006
Counties	10.29	10.15	1.85	2.12
Municipalities	10.32	9.27	10.72	7.55
Special districts	3.88	5.80	0.00	0.00
School districts	0.73	1.70	0.75	0.78
Share of General Revenue from				
	Sales Tax		Income Tax	
	FY 1996–1997	FY 2005–2006	FY 1996–1997	FY 2005–2006
Counties	6.43	6.42	1.16	1.34
Municipalities	7.41	6.76	7.80	5.51
Special districts	2.62	3.88	0.00	0.00
School districts	0.33	0.76	0.33	0.35

Source: U.S. Census Bureau (2009).

than are sales taxes, they are more important to these governments than to other forms of local government, yielding 11.95 percent of tax revenue, 7.55 percent of own-source general revenue, and 5.51 percent of general revenue.

- *Counties.* Counties, the other form of general purpose local government, raise 17.08 percent of tax revenue, 10.15 percent of own-source general revenue, and 6.42 percent of general revenue from their sales taxes. These percentages are much higher than the comparable ones for local income taxes: 3.57 percent of tax revenue, 2.12 percent of own-source revenue, and 1.34 percent of general revenue.
- *Independent school districts.* School district revenue systems rely on local sales and income taxes only to a modest extent: sales taxes yield 2.09 percent of tax revenue, 1.70 percent of own-source general revenue, and 0.76 percent of general revenue, while income taxes yield 0.96 percent of tax revenue, 0.78 percent of own-source revenue, and 0.35 percent of general revenue. The low share of general revenue reflects the significance of state transfers in the finances of school districts. A small number of states are responsible for even this modest reliance: for sales tax, Georgia, Iowa, Louisiana, Pennsylvania, and South Dakota; for income taxes, Iowa, Kentucky, Ohio, and Pennsylvania (U.S. Census Bureau 2008b).⁷ Only in Louisiana does the nonproperty tax yield more school revenue than does the property tax. The property tax remains the dominant tax for independent school districts.
- *Special single purpose districts.* Special districts do not levy local income taxes, but some do collect local sales taxes. Local sales taxes constitute 23.47 percent of special district tax revenue, 5.80 percent of their own-source revenue, and 3.88 percent of their general revenue. The considerable drop in reliance from tax share to own-source revenue share is explained by the fact that special districts typically rely heavily on user charges and have modest taxing authority. But when they do have taxing authority beyond the property tax, it usually is for a sales tax. The districts that collect the bulk of the local sales tax revenue are transit districts in Arizona, California, Colorado, Florida, Georgia, Illinois, Ohio, Texas, and Washington.⁸

7. These data are for independent school districts only, not primary and secondary education systems that function as a department of a city or other unit of government, e.g., schools in New York City and Chicago. Dependent schools are supported by the revenue system that their government employs, which may involve local sales or income taxes. But these are considered taxes of that government, not the schools, because the governing bodies of the government are responsible for their levy.

8. These data do not include the 3/8 percent Metropolitan Commuter Transportation District sales tax levied in Dutchess, Nassau, Orange, Putnam, Rockland, Suffolk, and Westchester counties and New York City because, although the revenue and geographic coverage are local, it is imposed by the state government, not by a local authority. A recent study counted

The data show that sales and income taxes contribute to the locally determined revenues available to local governments. That gives local governments more fiscal options in terms of varying the sizes of local budgets, the mix of taxes used to support those services, or some combination thereof. Not all localities have the option, not all that have the option use it, and its importance varies dramatically across localities. In terms of the national revenue structure, revenue from local sales and income taxes is concentrated in a relatively small number of states. Even though the totals are modest in the national aggregates, the taxes can make a significant contribution to the finances of localities with authority to adopt them.

The economic and fiscal impacts of these taxes will be considered later. First it is important to understand the structural and administrative choices involved in designing these taxes and some of the implications of how the taxes are structured.

Structure and Administration of Local Sales and Income Taxes —

In most states, local governments in the United States are limited in the sorts of taxes that they might levy; even in a single state, not all varieties of local government are afforded the same tax options. States also vary in the extent to which a tax alternative, if allowed, must follow a particular structural and administrative pattern. Interstate coordination might simplify compliance and administration, but that is not the path taken for local governments. As a result of these state-by-state choices, the pattern of local nonproperty taxation is characterized by considerable variation.

One immediately apparent difference between local sales and income taxation, shown in tables 6.2 and 6.3, is in terms of numbers: the local sales tax is levied in 36 states, ranging from New York to Alaska, Hawaii, and Florida, while the local income tax is levied in only 14 states. While the spread of income taxes seems nationwide, in point of fact the heaviest utilization is in the northeastern quadrant of the country: Indiana, Michigan, Kentucky, Ohio, Pennsylvania, New York, New Jersey, Maryland, and Delaware.⁹ While there are a few more states levying sales taxes than levy broad individual income taxes, the difference is far less pronounced than the difference in the local counterparts. From 1998 through 2002 and since 2005, state individual income taxes have yielded more revenue

16 states with transit districts imposing sales taxes: Alabama, Arizona, California, Colorado, Georgia, Illinois, Louisiana, Missouri, Nevada, New Mexico, New York, North Carolina, Ohio, Texas, Utah, and Washington (Goldman and Wachs 2003, 25).

9. City sales taxes have been authorized in West Virginia; county income taxes have been authorized to finance transportation projects in northern Virginia; and county and city income taxes have been authorized in Georgia. The taxes have not been levied in any of these jurisdictions. Oregon municipalities and counties have home rule powers and could levy local sales taxes. However, there is a referendum requirement, and many proposed sales taxes have been defeated by the voters.

than state retail sales taxes, so the patterns at the local level do not mirror those at the state level. As noted earlier, in total local sales taxes yield almost double the amount produced by local income taxes.

LOCAL SALES TAXES

Local sales taxes match their state counterparts as general taxes on purchase or sale of goods and, sometimes, services.¹⁰ They all have provisions to accommodate adding the sales tax to the transaction price and, whether legally on the buyer or the seller, intend that the seller behave as a revenue conduit between the purchaser and the taxing government.¹¹ The taxes are intended to apply to retail transactions only, and purchases of business inputs or inventories are excluded from taxation by a suspension certificate system. However, a considerable portion of the tax base continues to be purchases by businesses: in localities with a significant manufacturing sector, local sales tax embedded in business cost almost certainly allows a share of the cost of local government to be exported out of the jurisdiction. Similar exporting occurs when jurisdictions host regional shopping malls. These localities enjoy a high sales tax base per capita not as a product of affluent residents, but because of the base swollen by the prospect of base exporting. Even though the local sales tax bases do not entirely match those of their states, coverage is similar. That means that their burden distribution will be regressive, tempered somewhat where food for at-home consumption is exempt.

Table 6.2 identifies the states in which local sales taxes are levied and provides some details about the tax in each.¹² Where the taxes are levied, they constitute a widely varied component of all local tax revenue in the state. They constitute more than 30 percent of local tax revenue in several states, including Alabama, Arkansas, Colorado, Louisiana, New Mexico, Oklahoma, and Utah, a share that results from factors that include the extent to which localities in the state adopt the tax, the extent to which adopting localities heavily exploit the base, and the utilization of other taxes by local governments. When more than one type of local government in a state has been authorized to levy a local sales tax, the combined sales tax rate can become high. The prime example is Chicago, where the

10. Some states permit local business or occupation license taxes at least partly based on gross receipts. These taxes differ from retail sales taxes in coverage beyond retail activity in having no scheme to allow businesses to recover tax by adding it to individual transactions, in having no mechanism for anti-pyramiding, and in often having rates that vary by size and type of business.

11. Compensating use taxes, where levied by the locality, do logically reverse this situation by expecting the purchaser to remit any tax that might be owed if the vendor does not collect and remit tax for the purchaser.

12. In 2008 West Virginia authorized municipalities to levy local sales taxes and even includes reporting lines for each on its vendor reports. However, at last report no jurisdictions have adopted the tax.

Table 6.2
Application of Local Sales Taxation Across the States, 2009

State (SST Member: F = Full, A = Associate)	Share of Local Tax Revenue in State from Local General Sales Tax, 2005–2006 (%)	Types of Localities Levying the Tax	How Administered
Alabama	38.3	Cities, counties	State, local, private collecting firms
Alaska	14.5	Cities, boroughs	Local
Arizona	26.0	Cities, counties	State, local
Arkansas (F)	47.7	Cities, counties	State
California	15.5	Cities, counties, special districts	State
Colorado	31.0	Cities, counties, certain special districts	State, local
Connecticut	—	—	
Delaware	—	—	
Florida	4.0	Counties	State
Georgia	26.4	Cities, counties, transit authorities	State
Hawaii	—	Counties	State
Idaho	—	Counties	State contracted
Illinois	5.4	Cities, counties, transit authorities, certain special districts	State
Indiana (F)	—	—	
Iowa (F)	11.4	Counties, cities	State
Kansas (F)	16.8	Cities, counties, trans- portation districts	State
Kentucky (F)	—	—	
Louisiana	52.2	Cities, parishes, school districts, certain special districts	Parish tax admin- istrations (unified e-filing with state)
Maine	—	—	
Maryland	—	—	
Massachusetts	—	—	
Michigan (F)	—	—	
Minnesota (F)	1.3	Cities, counties, transit improvement districts	State

Table 6.2
(continued)

State (SST Member: F = Full, A = Associate)	Share of Local Tax Revenue in State from Local General Sales Tax, 2005–2006 (%)	Types of Localities Levying the Tax	How Administered
Mississippi	—	Cities	
Missouri	22.5	Cities, counties, certain special districts	State
Montana	—	—	
Nebraska (F)	8.2	Cities	State
Nevada (F)	4.3	Counties, Carson City	State
New Hampshire	—	—	
New Jersey (F)	—	—	
New Mexico	39.0	Cities, counties (often earmarked rates)	State
New York	15.9	Cities, counties	State
North Carolina (F)	18.7	Counties	
North Dakota (F)	11.1	Cities, counties	State
Ohio (A)	7.8	Counties, transit authorities	State
Oklahoma (F)	40.0	Cities, counties	State
Oregon	—	—	
Pennsylvania	1.0	Cities, counties	State
Rhode Island (F)	—	—	
South Carolina	2.0	Counties, school districts, Indian tribe	State
South Dakota (F)	22.3	Cities, special jurisdic- tions (Indian tribes)	State
Tennessee (A)	26.6	Cities, counties	State
Texas	10.9	Cities, counties, special purpose districts, transit authorities	State
Utah (A)	34.6	Cities, counties (often earmarked rates)	State
Vermont (F)	1.1	Cities	State
Virginia	7.9	Counties, independent cities	State

(continued)

Table 6.2
(continued)

State (SST Member: F = Full, A = Associate)	Share of Local Tax Revenue in State from Local General Sales Tax, 2005–2006 (%)	Types of Localities Levying the Tax	How Administered
Washington (F)	20.1	Cities, counties, regional transit authorities	State
West Virginia ^a (F)	—	—	
Wisconsin ^b	3.1	Counties, certain special districts	State
Wyoming (F)	17.6	Counties	State

^a West Virginia has explicitly authorized city sales taxes, but none have yet been adopted.
^b Wisconsin has petitioned for full membership.
Source: U.S. Census Bureau (2009).

city rate (1.25 percent), the Cook County rate (1.75 percent), the Regional Transit Authority rate (1 percent), and the state rate (6.25 percent) combine to the disconcerting total of 10.25 percent.¹³ Some states establish limits for combined local rates (Texas) or make one local tax a credit against another (California), but uncoordinated overlapping rates are more frequent.¹⁴ Table 6.4, a distribution of combined state and local tax rates in Cook County, Illinois, illustrates the variation that can result when several overlapping units have taxing authority and some rate flexibility. The contribution to both fiscal autonomy and confusion is apparent.

The local sales taxes create an interjurisdictional issue beyond their revenue significance. The growth of sales activity flowing from vendors who lack physical presence within a state (through the Internet, catalogs, telemarketing, etc.) has created a problem for state sales taxes and for vendors with presence in a state. According to the commerce clause of the U.S. Constitution as interpreted by the Supreme Court in *National Bella Hess v. Illinois* (386 U.S. 753 [1967]) and *Quill v. North Dakota* (504 U.S. 298 [1992]), a state is not permitted to require vendors

13. This is not the highest rate in a major metropolitan area, however. In the cities of Pico Rivera and Southgate, California, the combined rate in 2009 is 10.75 percent, and in one part of Bellwood, a Chicago suburb in Cook County, Illinois, the combined rate is 11.5 percent. The Cook County rate increased from 0.75 percent to 1.75 percent in 2008 to produce the pattern of rates reported here. It was immediately controversial and blamed for loss of business to surrounding lower tax areas. After considerable political drama and intrigue, the county decided to reduce its rate to 1.25 percent in mid-2010.

14. Due and Mikesell (1994, 295–299) discuss the patterns of coordination in detail.

Table 6.3
Application of Local Income Taxes Across the States, 2009

State ^a	Share of Local Tax Revenue in State from Local Income Taxes, 2005–2006 (%)	Types of Localities Levying the Tax	How Administered	Coverage	Resident and Nonresident Rates
Alabama	2.6	Cities, counties	Local	Wages and salaries	Same for resident and nonresident
Alaska	—	—	—	—	—
Arizona	—	—	—	—	—
Arkansas	—	—	—	—	—
California	—	Cities	Local	Payroll expense tax	Same for resident and nonresident
Colorado	—	—	—	—	—
Connecticut	—	—	—	—	—
Delaware	7.6	Cities	Local	Earned income of individuals and businesses	Same for resident and nonresident
Florida	—	—	—	—	—
Georgia ^b	—	—	—	—	—
Hawaii	—	—	—	—	—
Idaho	—	—	—	—	—
Illinois	—	—	—	—	—
Indiana	6.6	Counties	State	Broad on individuals and unincorporated businesses	Lower nonresident rate (may not be taxed)
Iowa	1.7	School districts, counties	State (surtax on state liability)	Broad on state liability	Resident only
Kansas	—	—	—	—	—

(continued)

Table 6.3
(continued)

State*	Share of Local Tax Revenue in State from Local Income Taxes, 2005–2006 (%)	Types of Localities Levying the Tax	How Administered	Coverage	Resident and Nonresident Rates
Kentucky	30.9	Cities, counties, school districts	Local	Wages and salaries and/or net business profits, 0.25 to 2.5%	Nonresident taxed by some, not taxed by others; rates same
Louisiana	—	—	—	—	—
Maine	—	—	—	—	—
Maryland	33.1	Counties, city of Baltimore	State	Broad on state base	Same rate for resident and nonresident
Massachusetts	—	—	—	—	—
Michigan	3.8	Cities	Local (state uniform law)	Broad income measure, individual and corporate	Nonresident taxed at lower rate (optional)
Minnesota	—	—	—	—	—
Mississippi	—	—	—	—	—
Missouri	4.3	Cities	Local	Earnings and net profits	Same for resident and nonresident
Montana	—	—	—	—	—
Nebraska	—	—	—	—	—
Nevada	—	—	—	—	—
New Hampshire	—	—	—	—	—
New Jersey	—	Cities	Local	Payroll	Same for resident and nonresident
New Mexico	—	—	—	—	—
New York	19.4	Cities	State	Broad base	Resident only
North Carolina	—	—	—	—	—

North Dakota	—	—	—	—	Same for resident and nonresident
Ohio	21.1	Cities, school districts	State (schools), cities, and regional collection agencies	Schools: individual: some broad base, some earned income only Cities: broad base for individuals and business	
Oklahoma	—	—	—	—	Business in jurisdiction
Oregon	3.6	Counties, transit districts	Local	Business income only	
Pennsylvania	16.5	Cities, school districts	Local	Earned income, net profits	Nonresident rates may be higher or lower than resident, including nontaxed
Rhode Island	—	—	—	—	
South Carolina	—	—	—	—	
South Dakota	—	—	—	—	
Tennessee	—	—	—	—	
Texas	—	—	—	—	
Utah	—	—	—	—	
Vermont	—	—	—	—	
Virginia	—	—	—	—	
Washington	—	—	—	—	
West Virginia	—	—	—	—	
Wisconsin	—	—	—	—	
Wyoming	—	—	—	—	

^a Colorado and West Virginia levy flat payment earnings tax on employer, which is not counted as income tax in this table.

^b Georgia authorizes city and county local income taxes, but none are levied.

Source: U.S. Census Bureau (2009).

Table 6.4
Combined State and Local Sales Tax Rates in Cities, Towns, and Villages in Cook County, Illinois, May 2009

Rate (%)	Number of Cities and Towns	Number of Villages	Total
9.00	6	43	49
9.25	1	5	6
9.50	1	10	11
9.75	2	10	12
10.00	10	36	46
10.25	3	5	8
10.50		1	1
10.75			
11.00			
11.25			
11.50		1	1
Total	23	111	134

Source: Illinois Department of Revenue, *Illinois Tax Rate Finder* (<https://www.revenue.state.il.us>).

with no physical presence in the state to register as collectors of the state's sales (or compensating use) tax because such a requirement would put an undue burden on such vendors. Under the existing system, businesses would be required to understand the sales and use tax base, rate, structure, and regulations of each state—because an order from a customer could come from anywhere—and, particularly acutely, to understand all that for each locality that also levied a tax. That could potentially mean thousands of taxes to be understood and complied with. It would not be a particular problem for vendors with physical presence; they have a location in the state and could reasonably be expected to understand the indigenous tax structure. The Court ruled that the system is too complicated to impose on a business that lacked a physical presence in the state. The Court also held that Congress may allow states to require remote sellers to collect tax when Congress becomes convinced that so doing would not be excessively burdensome. The uncoordinated sales taxes and, crucially, the uncoordinated local sales taxes made the burden on out-of-state (remote) vendors excessive as far as the commerce clause was concerned. Until Congress sees no undue burden, these vendors would remain outside the compliance system, and any collection of use tax would have to be done by action against the buyers of the goods.¹⁵ The major culprits in all this were the thousands of local sales (and use) taxes. Without

15. Some vendors have chosen to voluntarily register with the states.

them, remote vendors would only need to be familiar with forty-five tax laws, which surely would not be an excessive burden.¹⁶

To get the system changed, compliance must become less costly for remote vendors. A group of states created the Streamlined Sales Tax (SST) Governing Board, and their efforts to create a less complex system ultimately led to the Streamlined Sales and Use Tax Agreement.¹⁷ The agreement aims to simplify and modernize sales and use tax administration, thereby reducing the compliance burden. Before states may become part of the agreement program, they must change their state and local sales tax laws to conform with the simplified system. A number of requirements deal directly with local sales and use taxes:

- Local taxes must be administered by the state, using combined registration, filing, and remittance of funds. Localities may not conduct independent audits of vendors.
- Local jurisdictions must have a common tax base that is identical to the state base. There may be exceptions for motor vehicles, modular homes, and the like, but for the bulk of transactions, local and state taxability must coincide.
- Localities may change their tax rates only on a prescribed schedule, and states must maintain a database of all local tax rates linked to the ZIP codes in which the rates are applicable.
- For sales that are shipped or delivered within a state, tax collection will be at the destination of the transaction, not the origin, with some exceptions.¹⁸

There are, of course, many other elements in the agreement, but these are the ones that matter most for local sales taxation. Table 6.2 identifies the nineteen states that are full members of the agreement; full members with local sales taxes must follow the agreement standards. The associate members are moving toward full compliance. A considerable number of local sales tax states, including some states with a considerable share of the total U.S. population and the five states with highest total sales tax collections (California, Texas, Florida, New York, and Pennsylvania), are not members, often for political or fiscal reasons connected with the local sales taxes, particularly in regard to flexibility over selection of the tax base, entrenched local tax administrations, or defining taxability to site of delivery instead of site of the vendor.¹⁹

16. The issues are described in greater detail in Mikesell (2000).

17. The agreement appears at <http://www.streamlinedsalestax.org/index.php?page=modules>.

18. Beginning in 2010, states will be permitted to choose between origin and destination sourcing for their local sales taxes. This should make the streamlined program more attractive to some local sales tax states.

19. There are significant revenue distribution implications in origin- versus destination-based taxation. Washington State managed to join the SST group only by creating a program of

Even with the controlling backdrop of the Streamlined Sales Tax program, the states still differ in how their local sales taxes are administered. Because all states with local sales taxes except Alaska also levy state sales taxes, administration by the state is widely possible and has been the normal arrangement, even before the development of the SST program. With a state-local system, vendors collect the tax through combined brackets that cover both state and local liabilities on transactions and report and remit in combined returns. The state accumulates all returns and periodically transmits revenues back to the taxing localities. In this arrangement, the state and local taxes coincide in terms of covered transactions, exemptions, and reporting schedules, thus making compliance and administration much easier.

Local governments in some states, however, continue to administer their own sales taxes. Alabama even has some localities in which sales tax is administered by private collection firms.²⁰ Separate state and local administration normally results in tax bases that do not match entirely, dual compliance schedules, and dual administrative processes, thus vexing both vendors and customers. One exception is in Louisiana, where parishes administer the taxes for all localities in their boundaries and the parish administration coordinates an electronic filing system with the state so that filing is for both state and local taxes, even though administrations are legally separate.

Local administration does provide localities with greater control over their tax structures and quicker control over revenue, and it ends any dispute that, somehow, the state is not handling the distribution of collected revenue correctly. Local administration also ends any concern that the state administrators are not policing the local system as vigilantly (or too vigilantly) for local taxpayers. Local authorities covet the employees that local administration brings. However, seldom do the localities have the enforcement capacity of state revenue departments, and most states have reasonably prompt distribution of local taxes they have collected. Keeping revenue (and public employment) in the locality in which the sale occurred is almost certainly a major element in retaining the local system.

LOCAL INCOME TAXES

While local sales taxes, even those not administered by their state revenue departments, generally follow the same structure as the underlying state sales taxes, that structural similarity is not uniformly the case with local income taxes. Although

state transfer payments to mitigate revenue loss from the change. The streamlining program has brought no torrent of states switching from local to state administration. Since the early 1990s, only one state that had local administration, Minnesota, has switched to all state administration; Duluth, the only locality in the state that administered its own sales tax, switched to state administration in 2006.

20. Each firm collects more than a single local tax.

each state in which there are local income taxes also levies a broad individual income tax at the state level, the majority of local income taxes are administered by the local governments. Where there is local administration, there is little coordination across local jurisdictions, exceptions being the uniform law that must be followed in Michigan and the two regional collection agencies (the Regional Income Tax Agency, RITA, and Central Collection Agency, CCA) that collect a large number of municipal income taxes in Ohio (158 municipalities for RITA and 48 for CCA). Table 6.3 shows several critical features of local income taxes in each state in which the taxes are levied. The first difference from the local sales tax, in addition to the fact that there are far fewer local income tax states, is that the local income taxes are less productive within state revenue systems than are the local sales taxes. In only five states (Kentucky, Maryland, New York, Ohio, and Pennsylvania) do local income taxes generate as much as 15 percent of total local tax revenue.²¹ That is a far cry from the much greater reliance on the local sales taxes.

The local income tax bases are structured in ways that are significantly divergent and may or may not follow a pattern generally comparable to the federal tax or even to their overlapping state tax. The most closely linked to the state tax (and, through it, to the federal tax) are the taxes in Indiana, Iowa, Maryland, New York, and Ohio (schools only). These local taxes are administered by the state revenue department, and the local income tax is withheld, calculated, and reported within the state system. A combined return satisfies both state and local taxes. The state revenue department collects combined payments for state and local liability and returns the appropriate amounts to the localities. For most taxpayers, there is a nearly seamless connection between the two taxes. Remittances to the localities occur on a regular schedule, but usually not on exactly the same pace as revenues are collected from taxpayers.

Local income tax burdens should not be expected to be distributed as progressively as is the burden of the federal income tax. First, with few exceptions (New York City and Iowa school districts because the local tax is a percentage of the state liability, which is based on a graduated structure), the local income tax rates are flat and not graduated upward. Thus, the statutory rate pattern does not contribute to a progressive distribution. Second, a number of the local taxes

21. The data are from Governments Division, U.S. Census Bureau, because they are the most reliable, uniformly prepared figures. However, the Indiana data are problematic: the state has four different local income tax authorizations (with even more subdivisions in collections data as a result of special earmarking), each with distinct legal characteristics, and reporting confusions cause the census data to significantly understate Indiana's total local income tax revenue. The understatement may be sufficient to cause reliance to be in excess of 15 percent. As a result, the Indiana experience will be given somewhat greater attention than the reliance data in table 6.4 might otherwise warrant. Local income tax revenues are certified annually by the state Office of Management and Budget on the basis of actual collections from two years earlier, and that certified amount is distributed monthly to the taxing counties. The amounts distributed during the year are not directly linked to collections of that year.

apply only to payroll or earned income, thus omitting interest, dividends, capital gains, and so on from the tax base. These omitted types of income are particularly significant in the total income of more-affluent households, so the local tax in effect provides top-heavy relief not found in federal or state taxes. These two factors make the local income taxes in general somewhat less likely to have the progressivity of the federal income tax.

A larger number of states have local administration of the local income taxes, which are often, as just noted, limited to payroll. Such limited coverage makes enforcement somewhat simpler because administration can focus on employers in the locality, rather than trying to pursue payments made from outside the jurisdiction of the many recipients of wage payments, although at some sacrifice to equity. Some of the taxes attempt coverage of corporate income earned within the locality, using allocation formulas not unlike those used by states.

The local taxes vary in the relative treatment of resident and nonresident income earned in the jurisdiction. Income earned in the locality by nonresidents is usually, but not always (e.g., Iowa, Indiana, New York), taxed. The rates that apply to nonresidents are the same as or lower than those applied to residents. However, some local earnings taxes in Pennsylvania have higher rates for nonresidents than for residents. There is no consistent treatment for resident and nonresident income.

Local income taxation is subject to greater variety than is the case with local sales taxes. Although the localities could easily piggyback on state administration, that has not been the option most often selected. There is nothing like the SST project lurking behind local income taxes to attempt to induce either state administration or consistency between local and state bases. There is no pressure for such a project because subnational income taxes do not face the constitutional issues from the federal level that the sales taxes do.

Fiscal and Economic Impacts ---

SEPARATION OF SOURCES

A classical principle of tax coordination in federal systems is that of separation, that is, “to divide the major tax sources among the different levels of government, granting each of them exclusive jurisdiction over its own type of tax” (Break 1980, 35). This policy of dividing sources can provide useful returns to the federal system. In particular, such separation can strengthen local autonomy and accountability by ensuring access to a productive base without competition from another claimant. But probably more important is the improvement in transparency, whereby citizens can easily identify what they are paying for particular government services. When multiple governments are tapping the same base, which payment flows to which government may not be easily obvious, thus weakening the accountability chain.

Separation of sources in the American context would seem to leave local governments with the real property tax, a source whose reliability, stability, and

connection to place-specific local services make it attractive to local use. On the other hand, public unpopularity makes reliance on the property tax fiscally hazardous. Hence, it is not surprising that localities have sought the diversification to other broad-base taxes discussed here.

Local taxes on income and retail sales bring overlapping tax rates levied on a particular base. That will always be the case for local income taxes because of the federal tax, but in all the areas currently levying a local tax, there is also a state income tax. Furthermore, in a few states, more than one type of locality has taxing authority, creating a four-level situation. For local retail sales taxes, the overlap is between state and local in every state but Alaska, where there is no state tax, and also with multiple local jurisdictions taxing the same transaction in some locations. The violation of source separation provides local governments with an alternative to the property tax, but at some cost.

This tax overlapping produces two problems. First, adding local rates, sometimes from multiple localities, to rates levied by federal and state governments can produce high combined marginal rates. That has been previously noted in regard to retail sales tax rates in Illinois, but combined rates in excess of 10 percent also are levied in parts of Alabama, Arizona, Arkansas, California, and Louisiana. These combined rates are high enough to induce meaningful taxpayer evasion and avoidance strategies of some economic consequence. Similar impacts on marginal rates are also present with local income taxes, but with these taxes the federal tax adds to the combined rate. One significant example of high overlapping income taxes is in New York City, where the highest state and city marginal rates are, respectively, 6.85 percent and 3.65 percent. To that is now added a metropolitan commuter transportation mobility tax of 0.34 percent of payroll expense (or self-employment income). Local income tax rates elsewhere are seldom as high as 2 percent and are not graduated; the Iowa school district tax is levied as a percentage of state tax liability. In all applications, however, they do add to the marginal rate at which income is taxed.²²

The second concern about overlapping is added complexity for administration and compliance. When the local reporting and compliance systems are not coordinated with the comparable state tax, those responsible for paying and collecting the tax face added cost. For state-administered local taxes (tables 6.2 and 6.4 show whether the taxes are administered locally or by the state), those costs are usually reduced because a single compliance program satisfies both taxes. A single return—local tax compliance often being reduced to a single line on a state return—satisfies both liabilities. But not always: Ohio school district income taxes require a return separate from the state income tax return. When state and

22. The local income taxes are deductible for the federal income tax, thus mitigating the impact on taxpayers who itemize their deductions. They are also subject to recapture under the alternate minimum tax. Local sales taxes may also be deducted, but only if state and local income taxes are not deducted. If the state levies an income tax, the sales tax deduction is seldom the attractive option.

local administrations are not combined, multiple returns, often involving bases that are not quite the same, are the rule.²³ That added complexity is the price of maximizing local revenue autonomy and providing revenue diversification. But it does nothing to relieve concerns about the excess cost of raising revenue.

LOCATION EFFECTS

The rate that applies to a particular tax base influences the size of that base. As the rate is higher, households and businesses make decisions that reduce the base, and this influence is likely to be greater when taxpayers have easily available alternatives. Local taxes are particularly likely to show tax rate sensitivity because their relatively narrow geographic scope means that another fiscal regime with differing tax rates can be easily available. Obtaining different rates for the broad-based taxes often requires no more than crossing a city or county line, and sometimes there are rate variations even within a city or county. Sensitivity of the tax based to tax rates is a topic of considerable concern for localities having revenue autonomy. The distress is much less when all or almost all localities within a state have levied the local option tax, as with local sales taxes in Virginia and North Carolina, thus eliminating the intrastate differentials. However, given that service preferences and base endowments are not uniform across localities, it is often the case that there is no level rate plateau throughout the state.

The primary focus of concern about rate differences has been the local sales tax. Businesses complain about the loss of business to surrounding competitors when taxes are imposed or rates are raised. While the furor usually diminishes as retailers get used to the situation, the impact is real and continues as long as an adverse rate differential is in place. Evidence from a number of impact analyses shows the magnitude of the problem.

Efforts to estimate the loss have a long history. Hamovitch (1966) examined New York City sales tax data from 1948 to 1965 in a multiple regression analysis and concluded that around 6 percent of the implicit sales tax base was lost with each 1 percent increase in the city tax rate. Mikesell (1970) studied central city sales tax loss from adverse city-suburban tax rate differentials using census of business data for 1963 and found that a 1 percent increase in the city-surrounding area tax ratio caused per capita sales to be lower by 6.33 percent. Fisher (1980) examined the impact of rate differentials between city and surrounding suburbs on District of Columbia sales from 1962 to 1976 and found no impact on total sales, but found that a 1 percent increase in the rate differential brought a 7 percent decrease in food sales. Mikesell and Zorn (1986) found that a temporary sales tax rate increase in a small town had a relatively small impact on sales (a 1 percent rate differential reduced sales by 3.07 percent), but had no impact on vendor location. Wooster and Lehner (2009) examined per capita county retail

23. In Ohio a taxpayer may need to file a state income tax return, a school district return, and a city income tax return, the latter sent to a separate local administering unit.

sales in Washington State over the 1992–2006 period and found that a 1 percent rate differential reduced sales by 3.11 percent. Finally, in a somewhat different analysis, Mark, McGuire, and Papke (2000) examined sales tax rate influence on employment growth in localities in the Washington, DC, metropolitan area and found that a 1 percentage point increase in the sales tax rate reduced annual growth in employment by 2.17 percent. In total, these studies make it apparent that local sales taxes have an impact on the local economy whenever they are adopted or whenever rate increases create a rate differential. The measured impact appears to be in the range of 3 to 7 percent from a created differential of 1 percentage point. Using the local sales tax clearly has an impact on the local economy that must be part of the deliberations about how the revenue produced from the tax might be used in providing new services or in relieving other tax burdens.

Less is known about the specific distorting impacts of local income taxes in general. The reasons for this lack of work likely involve their lower overall importance in government finances, the far fewer instances of such taxes in the American system, the absence of usable and consistent data across jurisdictions for the tax base, the fact that capital income, arguably the most mobile of income sources, is excluded from many local taxes, and, for the several taxes that are residence based, limited direct incentives on employees in locating work facilities. A study by Mark, McGuire, and Papke (2000) examined income tax effects on employment and growth in counties in the District of Columbia area from 1960 to 1994. That analysis found the personal income tax rate to negatively influence population growth—a 1 percentage point increase in the personal income tax rate would reduce annual population growth by 0.81 percentage points—but the rate had no impact on private employment. Because all income taxes in that area were residence based, not point of employment based, such a pattern of effects is reasonable; changing place of employment would have no impact on local income tax liability, while changing place of residence could have an impact. While it is speculated that an employment-based tax—a payroll tax—might have a greater distorting impact, there is no direct empirical evidence on the question. Haughwout et al. (2004) found the elasticity of the New York City income tax to be around -0.5 , with a somewhat smaller elasticity in Philadelphia. Grieson (1980) estimated that a high-differential income tax rate in Philadelphia (three to four times that of the surrounding counties) had caused the city to lose 14 percent of its potential employment between 1965 and 1975. While the research on income tax effects shows a distorting impact, it is location-specific, and making general statements about the differential impacts is difficult. However, there is clear evidence that adverse differentials have a negative impact on the local economy.

REVENUE GROWTH AND STABILITY

The dynamic behavior of revenue is critically important to government policy makers because they need to finance the public services they provide. That behavior

is probably even more critical for states and localities than for the federal government because these subnational governments' ability to borrow to finance temporary deficits is far more restricted, and many must even work within some annual balanced budget requirement that, at least on paper, restricts their current spending to current tax and charge collections. Because the demand for local government services increases over time, and because some services cannot safely and prudently be adjusted downward in the face of declining government revenues, leaders of these governments are particularly interested in finding growing, but stable, revenue resources. Their reasons stem from both policy and political considerations and should be given considerable credence in considering local revenue programs, particularly as those revenue programs expand to broad alternatives to the property tax.

One argument that has traditionally been made in favor of the property tax in the finance of important local services—particularly primary and secondary education, public safety, and the judicial system—is its yield stability when the economy is in recession. Stable revenue provides the foundation for consistent services that need not be cut in the face of falling revenue. Kenyon (2007) examined the national pattern of local property, sales, and income taxes over the 1990–2006 period and found, when considering the three taxes according to annual percentage change, that the local income tax is far more unstable than either of the other two taxes and that the sales tax, usually almost as stable as the property tax, dropped substantially in the 2001 recession, while property tax revenue actually rose. This finding provides some useful information, but local financing is a state and local matter, not a national one. It is more helpful to go below the national aggregates and examine the behavior of the three important local taxes at the state level, and it is important to look at both growth and stability. If a revenue source shows measured stability but is slow growing, it will not be particularly attractive to local governments facing increasing demands for government services.

This state-by-state examination of local property, income, and sales tax revenue focuses on states in which local governments collect \$1.5 billion in revenue from the local income tax, the local sales tax, or both. It examines state totals of the local revenue sources, but excludes states in which there was considerable restructuring of terms of coverage of either income or sales taxes or considerable increase in the number of localities that levied the tax in the period examined, changes that would distort the local revenue data and any conclusions that might be drawn from them. The purpose of the investigation is to examine both the growth and stability features of local property, sales, and income taxes at the state level. The analysis covers fiscal years from 1984–1985 through 2005–2006, using data from the Governments Division of the U.S. Census Bureau. When new authority to levy one of the property taxes was provided by a state during the longer period, the analysis was done for the shorter data series. Analysis could be done for 28 states, as shown in table 6.5.

Annual revenue change was measured in two alternative ways. First, the growth rate was calculated according to the long-term trend. The growth rate (b) is estimated from an ordinary least squares regression of log revenue ($\ln R_t$) on the $TIME$ variable (1984–1985 = 1):

$$\ln R_t = a + b TIME_t + e$$

The rate is calculated for property, sales, and income tax revenue for each of the 28 states. These results appear in table 6.5.²⁴ Second, annual change is measured according to the average percentage change from year $t - 1$ to year t in the revenue data for each source for each state, the method used by Kenyon (2007).²⁵ A growing source will have a higher change rate. This change is also presented on an average absolute basis to allow for the fact that changes are both positive and negative. Big positive changes with big negative changes in the series would cancel out in the simple average, thus concealing a true pattern of troubling instability.

These three sets of annual change measures are presented in table 6.5, and, fortunately, the results are consistent across the alternatives. According to each measure, the annual change in local property tax revenue is usually less than for either sales or income tax. The property tax growth rate is highest in seven of the twenty-eight states; the average annual change in property tax revenue is highest in six of the states; and the average absolute annual change is highest in five of the states. The growth pattern is slower for the property tax than for either of the other two broad-based taxes, regardless of the measure examined. Even though there are fewer states with income tax than with sales tax, the results still provide a rather clear indication of which of the two is faster growing. The growth rate is highest for the sales tax than for either the property or income taxes in eighteen of the states with local sales taxes; the average annual change was highest in nineteen of the states; and the average absolute annual change was highest for the sales tax in twenty states. Where a local retail sales tax is levied in a state, the sales tax revenue is quite likely to grow more rapidly from year to year than is the revenue from either the local property or local income tax.

Revenue stability is examined through two alternative measures: the standard deviation of residuals from the growth trend and the coefficient of variation of annual percentage change. These measures are also reported in table 6.5. Again, the results are consistent among the alternate measures. When measured by the standard deviation of residuals or by the coefficient of variation, the property tax

24. This is an approach used in Dye and Merriman (2004) and in Dye and McGuire (1991). In a study of state-level tax stability, however, Giertz (2006) uses the standard deviation, thus not adjusting for differences in the average change.

25. Carroll and Goodman (2008) use this measure, for example.

Table 6.5
Growth and Stability of Collections from Local Property, Sales, and Income Taxes, Fiscal Years 1984–1985 Through 2005–2006

State	Local Tax Growth Rate (%)			Standard Deviation of Residuals from Growth			Average Annual Change (%)			Coefficient of Variation for Annual Change		
	Property	Sales	Income	Property	Sales	Income	Property	Sales	Income	Property	Sales	Income
Alabama	6.95	6.50	5.06	0.0219	0.0663	0.1238	7.05	7.36	5.80	0.3777	0.5167	2.4847
Alaska	2.83	5.41		0.0516	0.0801		3.66	6.19		1.1741	1.3158	
Arkansas	1.44	12.02		0.1863	0.0995		3.82	12.85		3.1408	0.8453	
Arizona	6.48	9.97		0.0815	0.0659		7.94	10.42		0.6829	0.5646	
California	5.46	6.30		0.0700	0.1007		6.39	6.38		0.8030	1.7885	
Colorado	5.42	7.32		0.0326	0.0464		5.88	7.21		0.4419	0.5808	
Delaware	6.41		5.47	0.0518		0.0554	7.12		6.11	0.5040		1.0873
Georgia	7.13	9.24		0.0726	0.1783		8.11	11.44		0.4843	1.3839	
Indiana	6.49		7.80	0.0720		0.2577	7.42		11.12	1.3971		1.4493
Kansas	4.31	7.38		0.0571	0.1054		4.90	9.23		0.9769	1.1988	
Kentucky	7.17		7.45	0.0353		0.0868	7.24		8.87	0.3651		1.2025
Louisiana	5.22	5.86		0.0352	0.0605		5.53	5.71		0.4857	0.9116	
Maryland	5.54		6.83	0.0759		0.0456	5.85		7.50	0.9752		0.6231
Missouri	6.73	6.85	3.59	0.0493	0.0314	0.0596	7.20	7.02	4.36	0.9083	0.4914	1.8906

North Carolina	7.31	5.02	0.0285	0.1269	7.75	7.25	0.3002	1.3008
Nebraska	4.05	7.30	0.0502	0.0681	4.69	7.27	0.8450	0.6368
New Mexico	7.17	8.26	0.0319	0.0829	7.23	9.52	0.5890	0.7024
New York	4.42	4.58	5.86	0.0735	0.0870	5.11	7.18	0.6356
Ohio	5.45	7.57	5.46	0.0370	0.0726	8.29	6.01	0.3774
Oklahoma	4.29	5.80	0.0706	0.0458	4.44	5.50	1.2648	0.6935
Pennsylvania	5.47	7.72	3.72	0.0449	0.1031	8.24	4.13	0.3160
South Dakota	4.13	6.96	0.0428	0.1073	4.28	8.97	0.8607	1.3159
Tennessee	6.46	5.18	0.0310	0.0880	6.83	6.23	0.3862	1.0190
Texas	6.54	6.96	0.0414	0.0763	7.18	7.76	0.4096	0.7710
Utah	5.58	8.07	0.0279	0.0961	5.91	7.53	0.6025	1.0034
Virginia	6.34	5.03	0.0721	0.0391	7.44	5.75	0.4798	0.5534
Washington	7.67	7.06	0.0631	0.1036	7.87	8.20	0.4305	0.9001
Wyoming	2.35	7.89	0.1840	0.1138	2.96	7.94	3.4460	1.2905
Mean	5.53	7.09	5.69	0.0604	6.13	7.81	6.78	0.8442
Standard deviation	1.57	1.70	1.49	0.0393	1.44	1.89	2.20	0.7542
Minimum	1.44	4.58	3.59	0.0219	2.96	5.11	4.13	0.3002
Maximum	7.67	12.02	7.80	0.1863	8.11	12.85	11.12	3.4460
								1.7885
								2.4847

Source: U.S. Census Bureau (2009).

is least stable in six states (four are the same according to both measures). On the other hand, the sales tax is least stable in seventeen of twenty-five states by the standard deviation of residuals measure and sixteen states by the coefficient of variation. The income tax is least stable in six of nine states according to the standard deviation method and seven states by the coefficient of variation. The results make it clear that the least stable broad-base local tax is the retail sales tax, and the most stable is the property tax.

The dynamic evidence is clear. As local broad-base taxes are structured in the United States, revenue from the property tax is slowest growing, and revenue from the sales tax is fastest growing. The individual income tax results are between the two. However, the results are reversed for revenue stability: the property tax is most stable from year to year, while the sales tax is most unstable. There are alternative ways of measuring both growth and stability, but these conclusions are consistent across the alternatives. If local governments need a stable revenue source, the property tax is the best broad-based alternative. They can obtain a higher growth rate with a local sales tax, but at the cost of greater year-to-year instability of revenue. Heavy reliance on retail sales tax revenue should be accompanied by a clear strategy for dealing with revenue fluctuations on the down side.

FISCAL DISPARITY

Tax bases are not uniformly distributed across localities within a state. This horizontal fiscal imbalance creates a problem in the intergovernmental system. As Oates describes it, “for a specific amount of local public services, an individual in a wealthier community will have a smaller tax bill than his equal in a poorer locality. Therefore, from the standpoint of the system as a whole, equals tend not to be treated equally. . . . An individual in a relatively poor locality will, in effect, pay a higher price for public goods and services than he would in a wealthier jurisdiction” (Oates 1972, 82–83). Putting individuals on an equal footing in regard to their relationship with local government is a significant factor in effective decentralization, particularly when local functions have both an important local impact and an impact on surrounding jurisdictions. With local governments responsible for such services as primary and secondary education, public safety, and elections, providing something approximating comparable options for all is an important state concern.

Local taxes provide a greater degree of fiscal autonomy, but because tax bases are not uniformly distributed, state governments will face considerable pressure to install transfer programs to even out revenue options across localities. The greater the degree of base disparity, the greater the need for state transfers and the greater the loss of fiscal autonomy (and fiscal responsibility) associated with those transfers. Therefore, when considering broad-based tax options for local governments, it is useful to understand which bases are more disparate than others. This section provides information about nonproperty tax disparity, compared with property tax disparity, for local bases in a number of states. It is assumed that the

property tax is the fiscal base for local revenue autonomy, which is certainly accurate in chronological terms, and thus it provides the standard against which the nonproperty taxes are considered. Unfortunately, usable data for such analysis are not available in many states, so the number studied is limited.²⁶

Table 6.6 presents the horizontal balance data for a number of local sales tax and local income tax states. The selection of states is based on availability of data required for the analysis. Only states in which a reasonably high number of localities have adopted the available nonproperty tax are included so that the analysis could encompass a broad spectrum of the states and could be done with actual local revenue data, not an extrapolation from other sources of what the tax might yield. These restrictions limit the number of jurisdictions that could be examined, but do provide some assurance about what the examination shows. The table includes fiscal disparity data for jurisdictions in Ohio (income tax cities and sales tax counties), Maryland (income tax counties), Indiana (income tax counties), Virginia (sales tax counties and independent cities), and regions of California (sales tax cities). All analysis employs data from the tax administrations of each individual state and embeds the structural features that define the taxes as applied in the individual states, not a standard or idealized concept of what the property or nonproperty taxes ought to tax.

A number of conclusions can be drawn from the results displayed in table 6.6. First, the property tax base per capita is usually larger than the base for either of the nonproperty taxes. The notable exception is with the income tax in Ohio cities. But in the other jurisdictions, the property tax base is larger, frequently by a wide amount: the stock measure of wealth is greater than the flow measure of income or consumption. A given statutory rate will be more productive when levied on property than when levied on income or consumption. However, along with the basic economic situation, the way the tax law defines the base will also contribute to the size of the base.

Second, the per capita property tax base is always positively correlated with per capita income and sales tax bases, but the correlations seldom are greater than 0.60 and can be much lower. In the case of cities in California's Bay Area metropolitan district, the correlation is only 0.13. While high-property-value localities are likely to have higher income and retail sales tax bases, there is usually not a particularly strong relationship between them. A high property tax base per capita does not mechanically imply that the jurisdiction will also enjoy a high nonproperty tax base per capita. That opens the possibility that local sales or income taxes might mitigate the problem of horizontal fiscal imbalance.

Third, all three tax bases show considerable disparity as measured by the coefficient of variation, and there is great difference in coefficients for each base.

26. Lewis (2001) shows that in California, where the prospects of raising additional revenue from the property tax are severely constrained, cities practice "fiscal zoning" to capture certain sales-tax-base-rich property developments, to the detriment of other uses.

Table 6.6
Horizontal Fiscal Imbalance and Local Nonproperty Taxes

Jurisdiction	Local Fiscal Disparity Characteristics: Income and Property Tax (per capita values)						
	Number	Dollars per Capita for		Correlation	Coefficient of Variation		Coefficient of Variation
		Income Base	Assessed Value		Income Base	Assessed Value	
Ohio cities	218	32,403	23,599	0.653	0.730	0.564	0.562
Maryland counties	24	21,114	112,832	0.523	0.370	0.580	0.456
Indiana counties	92 ^a	17,705	45,832	0.581	0.219	0.278	0.256

Jurisdiction	Local Fiscal Disparity Characteristics: Retail Sales and Property Tax (per capita values)						
	Number	Dollars per Capita for		Correlation	Coefficient of Variation		Coefficient of Variation
		Sales Base	Assessed Value		Sales Base	Assessed Value	
Ohio counties	88	9,998	12,295	0.684	0.301	0.268	0.262
Bay Area, California, MSD cities	65	19,505	210,632	0.133	2.570	0.680	1.340
Southern California MSD cities	121	77,026	484,453	0.897	6.170	6.670	6.660
Virginia localities	134	12,244	98,546	0.268	0.791	0.548	0.510
Virginia counties	95	8,571	99,052	0.354	0.532	0.527	0.488
Virginia cities	39	21,190	97,311	0.400	0.598	0.604	0.544

^a Indiana: 92 counties, but data are available for only 90.

Source: Data from reports from state departments of revenue or taxation and legislative review agencies.

The coefficient is higher for the income base than for the property base in Ohio cities (where the tax is narrower than the state or federal taxes), but is lower in Indiana and Maryland (where the local income tax is piggybacked on the state tax). The coefficient is higher for the sales tax base than for the property base in the Ohio counties, the California Bay Area cities, and the Virginia counties, but the reverse is true in the Southern California cities and the Virginia cities. The disparity coefficient is huge for both retail sales and property taxes in the Southern California cities. However, the evidence does not show that any of the bases is clearly superior in terms of lower horizontal fiscal imbalance.

Finally, the table shows the imbalance results from a representative nonproperty and property tax combination, thus examining whether the addition of a local nonproperty tax might mitigate the imbalance produced by total reliance on the property tax. The approach used here is derived from the representative tax system approach developed by the Advisory Commission on Intergovernmental Relations (1982) and usefully continued by Robert Tannenwald and colleagues (Tannenwald and Turner 2004). The effective tax rate for each base is calculated for each locality, and the state average (the representative rate) is then calculated. The yield for each locality from application of this average rate is calculated for both property and nonproperty taxes, and a per capita yield is calculated. This yield is the measure of representative tax capacity from application of the nonproperty tax and the property tax in the locality. This extra test can show the extent to which a nonproperty and property tax combination can create a base with less horizontal imbalance than a property tax alone. The data show that, while the combined base yields less disparity than the property tax alone, the change in the coefficient of variation is modest. The addition of the hugely disparate sales tax in the California Bay Area actually produces greater imbalance than with the property tax. A base that includes both a property tax and a nonproperty tax is not likely to make much difference in terms of the extent of fiscal equalizing transfers that a state might be required to grant in the quest for horizontal balance of fiscal resources.

Local sales and income taxes can provide local governments with additional fiscal resources to draw on as they seek to finance their assigned governmental service responsibilities, and can allow them to reduce some of the pressure that servicing financing can place on the property tax base. The distribution of these tax bases across local jurisdictions, however, shows considerable disparity, often even greater than found with the property tax. Furthermore, the disparity in the nonproperty tax bases does not work to significantly counterbalance the disparity in the property tax base: jurisdictions that have high endowments of the one base tend to also have reasonably high endowments of the other base, so adding the two bases together does little to smooth out combined fiscal capacity and reduce overall horizontal fiscal imbalance.

Summary and Considerations About Sales and Income Taxes in a Local Revenue System

Property taxes, predominantly levied on real estate, constitute the foundation of tax revenue collected by local governments in the United States. They provide the basis for local fiscal autonomy, providing a generally stable revenue source for finance of local services that are valued by the public and contribute to the value of property parcels in the service area. Their reliability, stability, and difficulty of evasion make them particularly useful for governments serving small geographic areas with limited capacity to finance revenue shortfalls by borrowing. In fiscal

2006 local governments collected more than \$347 billion from property taxes, more than 45 percent of their total general revenue from own-sources and 71.7 percent of their total tax revenue (U.S. Census Bureau 2008a). But local governments raised more than \$55 billion from retail sales taxes and \$28 billion from income taxes, and these sums would be difficult to replace.

Local sales or income taxes, where states permit them to be levied, can provide local governments with more fiscal options and autonomy. They can provide for greater fiscal self-reliance and do afford some relief of the property tax burden. The taxes are more frequently adopted by cities or counties, but also provide significant revenue for school districts and other special purpose local governments in a few states.

The local sales taxes have a regressive burden distribution, mitigated somewhat when food for at-home consumption is exempt. Local income taxes cannot be expected to be as progressive as the federal income tax because, first, the local tax statutory rates tend to be flat, not graduated, and, second, many local taxes do not include types of income (interest, dividends, etc.) that are particularly significant in the total income of more-affluent taxpayers in their base.

The taxes may be self-administered or administered by the state. State administration is more common for sales than for income taxes, and local sales taxes are more likely to be closely patterned after their state counterpart than are local income taxes.

Local sales taxes appear to have a negative impact on local retail trade, with estimates of the impact of a 1 percentage point tax differential ranging from 3 to 7 percent. Less is known about local income tax effects in general, although the distorting impacts of an adverse income tax rate differential have been shown to be significant in several city studies.

Because local governments are responsible for provision of services of crucial significance for modern society, it is important for them to have revenue sources that grow and are not subject to violent fluctuations. Evidence indicates that local sales tax revenue grows more rapidly than property tax revenue, but that revenue from the former is much less stable. Local income tax revenue is between the two other taxes in both growth and stability.

Finally, fiscal resources are not uniformly distributed across localities, leading to problems of horizontal fiscal imbalance. Neither local income nor local sales taxes have much impact on altering the disparity created by property tax reliance.

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