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# III

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## Characteristics of a Balanced and Moderate State-Local Revenue System

by

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The authors of this chapter originally planned to describe the characteristics of a "high-quality" tax system. It became apparent, however, that the term *high quality*, like goodness, is in the eye of the beholder. It was decided, therefore, to use a more objective title—"Characteristics of a Balanced and Moderate State-Local Revenue System."

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The ideal state-local revenue system places heavy emphasis on three values—balance (revenue diversification), tax fairness (shielding low-income households from the tax collector's reach), and moderation (tax rates and trends in revenue growth that do not deviate too far from the average).

It must be emphasized, however, that differing value systems produce different "ideal" state-local revenue systems—a truism powerfully underscored by the great diversity found in the American federal system.

- If the highest goal is attractiveness to high-income individuals and investors, then the Texas model is best because that state has neither a personal nor a corporate income tax.
- If a distinctly progressive tax system is preferred, the Minnesota model receives very high marks because that state leans heavily on a progressive personal income tax for the financing of public services.
- If local political accountability becomes the central consideration, then New Hampshire's model certainly receives the top prize because that state makes intensive use of the local property tax for the financing of public services.
- If the central objective is to maximize the amount of taxes paid by nonresidents, then the Alaskan approach comes to the forefront because that state derives most of its tax revenue from energy-producing corporations.

The concern for building greater balance into the revenue systems of most states stems from the authors' belief that states and localities will be operating in an increasingly harsh and competitive fiscal environment over the next several years. To put the issue more directly, state policymakers will be under growing pressure to reshape their revenue systems to reduce their vulnerability to economic recessions, taxpayer revolts, growing interstate competition for jobs, and cutbacks in federal assistance. The move toward more "balanced" and moderate tax systems holds the best promise of reconciling the need for states to reduce their fiscal vulnerability while still permitting them to maintain equitable and effective revenue systems.

## Seven General Guidelines

The authors' "balanced" state-local revenue system is designed to achieve three goals: a fair and proportional distribution of the tax load; moderate levels of income, property, and sales taxation; and an equilibrium between the growth of tax revenue and the income of taxpayers. Seven policy strategies can help states attain these "middle-of-the-road" fiscal objectives. *While most of these strategies have received the seal of good housekeeping from the Advisory Commission on Intergovernmental Relations (ACIR), this "balanced" state-local tax system does not carry the ACIR imprimatur. It simply represents the views of the authors of this paper.*

### *Revenue Diversification*

The state-local revenue system should be marked by revenue diversification—fairly equal reliance on the big three (income, property, and sales taxes), with user charges and "all other" revenue sources rounding out this picture.

The need for revenue diversification has its roots in the hard fact that there is no ideal tax. The more intensively a jurisdiction makes use of any one of these revenue sources, the less obvious become its unique advantages and the more apparent its unique disadvantages.

For the federalist, revenue diversification has a striking message. Widespread state use of both the sales and income taxes stands out as a powerful barrier against the centralization of fiscal power in Washington. It is for that reason that revenue diversification has received strong support over the years from the Advisory Commission on Intergovernmental Relations.

Only those states that have an above-average ability to export their taxes to nonresidents are in a position to ignore this revenue diversification prescription. For example, an energy-rich state such as Alaska can dismiss the revenue diversification advice as long as OPEC can prevent oil prices from plunging too low.

### *Revenue Stability and Moderation*

State policymakers in the late 1980s will be disciplined by a memory of the three Rs—revolt of the taxpayers, recession, and reductions in the flow of federal aid. In this era of "finance-it-

yourself' fiscal federalism, state policymakers no longer can count on the federal cavalry to come charging over the hill and relieve recessionary sieges with financial aid from Washington. To stabilize revenue flows, it is necessary to go beyond revenue diversification. For many states, there is also the need to broaden both sales and income tax bases and to scale down tax rates. These actions—coupled with the creation of Rainy Day Funds—should go a long way in helping states cope with sharp downturns in the economy and the growing stresses of interstate competition in economic development.

The chances of achieving a tolerable degree of revenue stability are greatly improved if state-local revenues increase at about the same clip as the economy of a state. If revenues lag far behind the growth of the state economy, there is frequently a need to raise taxes. If revenue growth runs well ahead of the economy, however, state and local policymakers run the real risk of triggering a taxpayers' revolt or fostering a poor business tax climate, or both.

### *Tax Fairness*

Although state officials should avoid highly progressive (Robin Hood-type) tax policies, they should not close their eyes to the need to shield subsistence income from the reach of state and local tax collectors. They can do this by (a) state financing of property tax circuit-breaker plans, (b) providing either tax credits (positive and negative) or exemption from the sales tax for the purchase of food, and (c) making sure that families below the poverty line are not required to pay a state income tax.

### *State Fiscal Equalization*

To guard against a local property tax overload situation and to promote local fiscal equalization, the state should be the senior partner in the state-local fiscal system. More specifically, the state should assume (a) at least 50 percent of the cost of "spillover" programs such as education, health, and hospitals, and (b) complete financial responsibility for the nonfederal share of public welfare. If the state prefers a more decentralized fiscal approach, it can share, unconditionally, a substantial part of its revenues with its localities on an equalizing basis. It also should be noted that local revenue diversification stands out as the preferred way to keep property taxes at reasonable levels if local political accountability is favored over interlocal fiscal equalization.



## *Political Accountability*

To ensure that tax increases are the product of overt legislative action and not the hidden consequence of inflation, state personal income taxes should be indexed for inflation. To put it more bluntly, elected state officials should not be allowed to hide in the inflationary weeds and watch taxpayers be bumped up gradually into higher tax brackets.

By the same token, a "truth-in-property-taxation" safeguard is also necessary to make sure that political responsibility for a property tax increase is focused squarely on the local legislative body and not on the assessor who raised tax assessments to reflect an increase in property values.

The adoption of these two political accountability safeguards—indexation and the truth-in-property-tax provision—should head off taxpayer revolts by helping to ensure a balance between the growth in tax receipts and the growth in taxpayers' income.

## *Property Tax Equity*

The central objective of state property tax policy should be to create an administrative and professional environment that will promote a fairly high degree of assessment uniformity, both within and between local assessment jurisdictions. The closer the state can push local assessment levels to full value, the more equitable the tax system. It is a truism of property taxation that fractional assessment serves as a convenient graveyard in which assessors can bury their mistakes and acts of favoritism.

## *Tax Competitiveness*

Because interstate tax competition for jobs is likely to become more fierce, most states must become even more concerned about avoiding a reputation for having a poor business tax climate. Like pornography, a bad business climate is hard to define, yet it is recognized when one sees it. It is marked by the appearance of several features—a relatively heavy tax burden; highly progressive tax policies; no provision for property tax exemptions for inventories, machinery, and equipment; no sales tax exemption for industrial machinery; the use of worldwide apportionment; a classified property tax and above-average rates for unemployment insurance and workers compensation. While the absence of these

"sore thumbs" does not ensure strong economic development, their presence certainly can work against it for all states except those in the strongest competitive position.

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## More Specific Guidelines

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This section discusses in detail current thinking about the desirable characteristics of a balanced state-local tax system. The income tax, the sales tax, the local property tax, business taxes, and excise taxes are each discussed briefly. The five traditional principles of taxation are combined with the new competitive orientation of taxation to produce what might be described as a pragmatic, forward-looking view of state and local tax policy.

### *Personal Income Tax*

The income tax generally is considered to be the cornerstone of a tax system, as it is the fairest, most productive revenue source available to state and local governments.

In fiscal 1984, the personal income tax accounted for 20.2 percent of state-local tax revenue. The personal income tax is a much more important tool to states (30 percent of all taxes collected) than to local governments (4.3 percent of all taxes collected). The income tax is used by every state except Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming. In Connecticut, New Hampshire, and Tennessee, the tax is applied only to unearned income (dividends, interest, and/or capital gains).

State and local income taxes vary widely in rates, deductions, exemptions, income definitions, and administration. Although no prescription for the perfect income tax exists, there are several generally agreed-upon criteria that should be given weight in the design of a state or local income tax:

- (1) *A personal income tax should provide 20 to 30 percent of all state-local tax revenue. Too heavy a reliance on the tax can have an adverse effect on a state's business climate, and too little reliance will increase the need to rely on regressive taxes with limited growth potential. Eighteen states fall within the recommended range.*
- (2) *The rates of an income tax, whether graduated or flat,*

*should not be markedly higher than rates in surrounding areas.* If rates are too high, several shortcomings of the tax become apparent. First, large interstate tax differentials are likely to have an adverse effect on location choices of taxpayers and the state's efforts to promote economic growth. High tax rates also may have an adverse effect on saving and investment. Second, highly graduated rates can create divisions of opinion about equitable distribution of the tax burden among income classes. Disagreements over the proper role of the state in redistributing income may make it difficult to raise income taxes to finance desired increases in government programs. Third, if states rely too heavily on the income tax, pressure mounts to modify the tax base by adopting exclusions, deductions, and credits. This narrowing of the tax base creates horizontal inequities—that is, taxpayers with equal incomes pay different amounts of income taxes.

A graduated rate has been favored by most states—only four levy a flat rate on all income—but a high-quality income tax does not have to use graduated rates. Graduated rates have been favored heavily because they are thought to be fairer (more progressive) and they increase the growth potential of the tax. Many state income taxes, however, have so little graduation that they differ little from a flat rate. For example, the top rate in Maryland begins at income over \$3,000.

There has been rethinking of the advantages of graduated income taxes in recent years as evidenced by the various proposals to reduce the number of brackets and the top rate of the federal income tax. High marginal tax rates generally are viewed as detrimental to economic growth because they discourage saving and reduce the incentive to work. The high elasticity of the graduated income tax no longer is considered a clear advantage, because it can permit excessive increases in government spending. As mentioned above, the new view is that revenue growth should not outpace economic growth. A final point is that the federal deductibility of state income taxes has encouraged graduated rates. If this deduction is eliminated, as has been proposed by President Reagan,

more states may move to flat rate (or modified flat rate) income taxes. In most cases, the result will be only a small loss in progression and growth potential, as generous exemptions and credits can make a flat rate income tax nearly as progressive as a graduated one.

- (3) *A state or local income tax should offer personal exemptions or credits at least as generous as the federal income tax exemptions.* Ideally, exemptions or credits should be generous enough to shield persons and families below the poverty line from paying income taxes. This will take on added importance if more states adopt flat rate taxes.
- (4) *The number of deductions allowed on state income taxes should be minimized.* A major criticism of the federal income tax is that it is unfair because it allows too many "loopholes" that higher income persons can use to reduce their taxes. Most tax reform efforts, including the president's proposal, are aimed at reducing the number of deductions, thereby simplifying the federal income tax and making it more equitable.

A number of states have adopted, wholly or partially, the deductions allowed on the federal income tax. Although this approach does simplify the state income tax, it narrows the base of the tax, requires higher rates, and results in the same unequal treatment of equals (horizontal inequity) that exists under the federal income tax.

- (5) *State and local income taxes should be indexed for inflation.* Indexation will prevent inflation from automatically pushing taxpayers into high tax brackets, ending unlegislated tax increases. In addition to reducing the responsiveness of income taxes to changes in money incomes, indexing prevents unintended changes in the vertical distribution of tax burdens. States with flat rate income taxes should index exemptions and credits. Ten states have enacted personal income tax indexing laws.
- (6) *A state should share the proceeds of the personal income tax with local units of government or permit local income taxation with proper safeguards.* There are no serious disadvantages to local use, but the income tax has not been widely employed by local government.<sup>1</sup> A local income tax is levied in only nine states and is



widely used in only five. (In Maryland and Iowa, the local tax is piggybacked on the state income tax.) Local government's reluctance to use the income tax largely can be explained by the traditional reliance on the property tax and the preemption of use of the tax by federal and state governments.

Sharing the state income tax with local governments would relieve pressure on the unpopular property tax and reduce the need for local governments to adopt their own income taxes. States should provide collection services for those local governments that do employ income taxes.

### *Sales Tax*

The general sales tax is the largest state revenue source, accounting for 32 percent of all state tax revenue and 23.4 percent of state-local tax revenue in FY 1984. Only five states do not levy a sales tax—Alaska, Delaware, New Hampshire, Montana, and Oregon.

The sales tax deserves heavy weight in a state-local tax system because it is: (1) productive; (2) relatively stable; (3) exportable to nonresidents, particularly in tourist states; and (4) according to most public opinion surveys, the least unpopular tax largely because it is viewed as voluntary by the taxpayer and is collected in small amounts.

Conventional wisdom holds that a good state sales tax should meet the following criteria:

- (1) *It should provide 20 to 30 percent of all state-local tax revenue.* This is a somewhat arbitrary range, but it is the authors' view that within this range a sales tax would contribute to a balanced revenue system—being neither under- or overused. Fourteen states fall into this range. Twenty-two states rely on the sales tax for less than 20 percent of state-local taxes, and 14 states rely on the sales tax for more than 30 percent of state-local taxes.
- (2) *The sales tax rate should not be out of line with rates in surrounding states.* An above-average tax rate can cause competitive problems for retailers, particularly those located near a state's border. The rate can become too high if the tax is overused, the base is too nar-

row, tax avoidance is high, or a high local sales tax is levied.

- (3) *It should exempt food, drugs, and utilities or provide a tax credit for purchase of these items.* The major weakness of a sales tax is that it is regressive. That is, the tax takes a larger percentage of income from low-income persons than from high-income persons. Exempting necessities such as food and utilities will reduce, but not eliminate, the regressiveness of the tax. There are 29 states that currently exempt food, 43 that exempt prescription drugs, and 32 that exempt utilities from the sales tax. One weakness of an across-the-board exemption is that high-income as well as low-income persons receive the benefit, making it very expensive. Also, these exemptions increase collection costs. A more efficient option is a rebatable credit against the income tax for the sales tax paid on necessities. This is used in nine states but is not popular because it is not very visible to the taxpayer.
- (4) *It should tax most services, as well as goods.* This improves the growth potential and the fairness of the tax and allows for a lower tax rate. Ideally, all forms of consumption should be taxed to avoid distorting consumer choices. For example, if one person wants to improve his appearance by purchasing a shirt and another wants to improve her appearance by getting a haircut, both should be taxed or both should be exempt. In most states, the shirt is taxed and the haircut, a service, is exempt.

Broad taxation of services should make the tax somewhat less regressive, since expenditures on services as a whole tend to be more income elastic than expenditures on goods. The most progressive services such as foreign travel and most personal household services, however, are difficult to tax. The services likely to be taxed such as laundry and dry cleaning, repair, and beauty and barber services may not lessen the overall regressivity.

The inclusion of services in the sales tax base also will improve the growth potential of the tax, as the service sector is growing faster than other sectors of the economy.

Finally, inclusion of services in the tax base

facilitates administration of the tax. Since many firms already are registered vendors and most distinguish between sales and services, taxing their entire receipts is much simpler. This practice also can assist in the collection of business use taxes—a major source of lost revenue.

- (5) *The proceeds of the sales tax should be shared with local governments, or localities should be allowed to levy sales taxes subject to state-imposed safeguards.* This approach will reduce the need for local governments to levy sales taxes. Use of the local sales tax has proliferated in recent years as many localities have been pressured to diversify their revenue systems because of the decline in the growth rate of the property tax and because of its unpopularity. Twenty-six states levy local sales taxes. In 1970, the sales tax accounted for 7.9 percent of local taxes; in 1984, the sales tax provided 14.5 percent of local taxes.

Although local revenue diversification is an appropriate response to changing fiscal needs, economic conditions, and taxpayer attitudes, a local sales tax is not the most desirable revenue source for that purpose. Its major weakness is that it can add considerable administrative expense and create serious competitive problems for retailers, particularly those who sell high-cost items such as coats, cars, and jewelry. A city that levies a local sales tax will encourage consumers to make their purchases in suburban shopping areas, which already have many advantages over central city shopping areas. Ideally, a local sales tax should cover all of a major trading area, as is often done with sales taxes imposed by transit districts.

- (6) *A strong audit and enforcement program should be maintained to protect the integrity of the tax base.* Many states do not have adequate audit programs and lose millions of dollars from tax evasion, particularly in the areas of mail order sales and out-of-state business purchases. Failure to establish an adequate audit program is costly in revenue loss and unfair to vendors who pay the correct amount of tax.

## *Property Tax*

Property taxes are the preeminent local revenue source and will continue to be so for the foreseeable future. In recent years, however, the trend has been toward a more diversified local revenue system. Nationally, in 1970, local property taxes were 64 percent of all local own-source revenue. By 1984, the property tax share had fallen to 47 percent, as local governments made greater use of sales and income taxes and user charges. If an adjustment were made for state-provided property tax relief, the declines would appear more dramatic.

The decline in the use of the property tax can be attributed to four factors: (1) self-imposed discipline as many local officials became concerned that individuals and businesses were being driven away by high property taxes; (2) voter-imposed restraints such as Proposition 13 in California and Proposition 2½ in Massachusetts; (3) greater elasticity of other revenue resources, such as sales and income taxes; and (4) increased state aid for education.

The property tax is the most criticized of the major taxes used by state and local governments. The major criticisms are that the tax (1) is unfair (regressive), (2) discourages improvements on property, and (3) encourages flight from central cities.

Despite its weaknesses, the property tax will continue to be the primary local revenue source because it has several important advantages. First, it provides a stable source of revenue for local governments. Second, it is productive, allowing for considerable local fiscal independence. Third, it is a means of taxing nonresident property owners who, because they are absent, escape income and other local taxes. Fourth, it is the only major tax that can recapture for the community some of the property value the community has created by providing good public services. Fifth, it provides fiscal accountability as there is a clear link between taxes paid and services such as local schools, police, and fire protection.

The virtues of a property tax can be maximized and the weaknesses minimized by adopting certain safeguards.

- (1) *The property tax should provide 20 to 30 percent of all state-local tax revenue.* If a jurisdiction relies too heavily on the property tax, its weaknesses become increasingly apparent. The residential property tax can cause hardship for low-income families, especially those living on fixed incomes. A heavy property tax burden also can distort the locational choices of business firms, as



well as of individual taxpayers. Because the property tax is so visible and is paid in a lump sum, intensified use of the tax has contributed directly to "taxpayer revolts" in many states. The result has been voter-imposed restrictions that limit the fiscal flexibility of state and local governments.

Many states have pushed the property tax beyond the upper limits of this "balanced" target. In 1983, there were 23 states in which property taxes made up more than 30 percent of all state-local taxes. In 11 of these, property taxes accounted for more than 40 percent of all taxes. There were 10 more states that fell below the minimum range. In many states, however, the dependence on the property tax has eased in recent years, partly in response to actual or threatened citizen initiatives. In 1972, there were 35 states in which property taxes exceeded 30 percent of all state-local taxes. The national average was 39.1 percent in 1972 compared with 31.4 percent in 1983. In 1983, there were 28 states that fell within the suggested range of 20 percent to 30 percent compared with 16 states in 1972.

- (2) *State and local governments should work together to ensure that the property tax burden does not become excessive.* As discussed above, a high property tax can have a detrimental effect on a state's economy and its taxpayers. Maintaining a balanced tax system is a safeguard against overuse of the tax, but a state with high taxes overall can have both a balanced system and a high property tax.

There are three ways to ensure modest use of the property tax. First, states should finance the non-federal share of welfare expenditures fully and finance a major share of the cost of elementary and secondary education. In 1983, the states financed 87 percent of state and local expenditures for public welfare (from own-source revenue), up from 76 percent in 1966. Only five states provide financing for less than two-thirds of welfare costs. The states financed 52 percent of the cost of elementary and secondary education, ranging from a high of 100 percent in Hawaii to a low of 7 percent in New Hampshire. The meager assistance for public education provided by the state of New Hampshire to local governments explains in large part why

property taxes were 63.5 percent of all state-local taxes in 1983 in that state, the highest in the nation. In Hawaii, where education is state financed and the sales tax is broad based, property taxes are only 18.4 percent of all state-local taxes, eighth lowest in the nation. There is a strong negative correlation between state support for education and local reliance on the property tax.<sup>2</sup> In other words, the higher the level of state support for education, the less local governments use the property tax.

Second, state governments should share general revenues with local governments to relieve pressure on the property tax, build greater growth responsiveness into the local revenue system, and reduce the fiscal disparities between the have and the have-not communities. The revenue-sharing formula should take into account the tax effort of each jurisdiction and the per capita property tax base.

Third, the states can authorize use of local income and sales taxes. Preferably, these taxes should be piggybacked on state taxes to minimize compliance and collection costs. As a final alternative, states would be well advised to: (1) limit local nonproperty taxing power to large taxing areas, ideally coinciding with the boundaries of trading and economic areas; (2) prescribe rules governing taxpayers, tax bases, and tax rates uniformly applicable to all taxing jurisdictions; and (3) provide technical assistance in administering and enforcing nonproperty taxes.

- (3) *States should finance a "circuit-breaker" property tax relief program to shield low-income taxpayers from excessive tax burdens.* The property tax generally is considered to be a regressive tax because it imposes a heavier burden, as a percentage of income, on low-income persons than on high-income persons. (Some studies have shown, however, that when measured against total wealth rather than current income the property tax is not regressive.) A property tax relief program (circuit-breaker) based on income can pull the regressive stinger from the tax and improve the vertical equity of the state-local tax system. As a rule of thumb, low-income homeowners and renters should not be required to pay more than 6 percent to 7 percent of

their income in property taxes. Most states provide special treatment for the elderly, a provision that has long been recommended by ACIR. Although this special treatment may be required politically, from an equity standpoint, relief should be based on income, not age.

There are two major criticisms of circuit breakers. First, as several studies have confirmed, these programs promote spending by making it easier for local governments to raise property taxes. Second, the programs reward the overhoused. That is, those persons that spend an above-average share of their income on housing will receive large benefits.

On balance, however, circuit breakers improve the equity of the property tax, particularly if a sliding-scale credit is used (the percentage of taxes not refundable rises as income rises) or the credit is phased out at higher income levels. In Michigan, for example, the credit is phased out between the \$65,000 and \$75,000 income level.

Thirty-one states and the District of Columbia use some form of circuit breaker. Most state programs cover only elderly and disabled homeowners and renters, with only eight states having a comprehensive program.

- (4) *Property should be assessed on average at no less than 80 percent of full market value (100 percent is the ideal).* The objective of this recommendation is to prevent low fractional assessments from providing a convenient graveyard in which assessors can bury their mistakes. If local assessors assess at a uniform rate of substantially less than 100 percent of market value, two important safeguards should be provided local taxpayers as part of the full value test. First, a full disclosure policy should be adopted requiring annual state assessment ratio studies by county. In addition, information on the level of assessments and the degree of uniformity in assessments should be readily available to local taxpayers. Second, an appeal provision should authorize the use of state assessment ratio data as evidence in taxpayers' appeals of their property assessments.

There are no states in which the statewide average assessment ratio for all property is 80 percent or more,

but the 1981 ratio exceeded 75 percent in Alaska, Kentucky, and Virginia. There are eight other states in which the ratio exceeded 60 percent. The sales assessment ratio for single-family homes exceeded or closely approached 80 percent in four states—Idaho, Kentucky, Oregon, and Virginia.

- (5) *Property tax laws should include a mechanism to prevent automatic, unrestrained increases in revenue from inflation-induced assessment increases.* An example of such a mechanism is a "truth-in-taxation" law that automatically rolls back property tax rates to offset increases in assessments unless local legislative bodies advertise the need for the tax increase and formally vote for the increase. Ten states use some form of full disclosure laws, all of which were adopted after 1970.

In several instances, these laws have been adopted to prevent more restrictive voter-imposed limits. It does not appear, however, that these laws have achieved this purpose.

Voter-imposed aggregate tax and expenditure limits, such as Proposition 13, which usually have been aimed at the property tax, represent more dramatic accountability constraints. Although overall tax and expenditure limits still may appear attractive to voters in the slow-growth era of the 1980s, they are not part of the ACIR model of a balanced state-local tax system. These overall limits can create inflexible constraints that could require continuous adjustments over time to reflect shifts in the desired levels of public services and changes in fiscal conditions, such as reduced federal aid. Also, the fiscal effects of limits are not at all clear at the time they are adopted.

- (6) *The property tax should be administered fairly and equitably.* A property tax system cannot work effectively if the taxpayers do not have confidence in the fairness of the assessment process. In addition to a fair appeal process, full disclosure policy, and truth-in-taxation law, there are three other requirements for a fair, professional system. First, the assessor should be removed from the elective process and selected on the basis of demonstrated ability to appraise property. Second, the state tax department and local assessing departments cannot work with a reasonable degree of



effectiveness unless they are given sufficient budgetary support, legal authority, and professional stature. Third, the property tax will not likely be viewed as fair if there is a wide variation in assessment ratios among classes of property and if the tax is riddled with exemptions.<sup>3</sup>

Two statistical measures can be used to measure the quality of a property tax assessment system. The first is the coefficient of *intra-area* dispersion for single-family houses, which measures the uniformity of assessment within a district. The larger this number, the less uniform the assessment system. The second measure is the coefficient of the *inter-area* dispersion for single-family houses, which measures the uniformity of assessments among assessing jurisdictions. The higher the coefficient, the wider the range of median assessment ratios in the different jurisdictions.

Data for 1981 indicate that the coefficient of intra-area dispersion ranged from 12.4 percent in Wisconsin to 78.9 percent in North Dakota. Thirty-two states fell between 20 percent and 40 percent. The coefficient of inter-area dispersion ranged from 3.6 percent in Oregon to 55.1 percent in Pennsylvania. Looking at these ratios historically indicates that only modest improvements in uniformity have been achieved in the past 20 years.<sup>4</sup>

### *Business Taxes*

It can be argued that for business taxation it is no longer sufficient to rely on the general principles that apply to taxes that fall directly on individuals. However, because of the confused and undeterminable distribution of business taxation and the conflicting interests involved, it is difficult to develop business tax principles that are widely accepted.

A fundamental issue in business taxation is whether states would do better to strive for a uniformly applicable, comprehensive, and nondiscriminatory business tax system or whether they should seek to tax businesses differently and selectively based on the inelasticity of demand for their outputs, or the inelasticity of their supply on inputs, or on the basis of their inability to relocate. The former approach may be more equitable, but the latter may be more efficient in maximizing revenue while minimizing political

discord and the effect on the economy and the business climate.

The desire to maintain a favorable business climate and remain competitive with other states is a major factor in the level of business taxes, but it does not explain completely why state and local governments select particular types of taxes. It can be argued that sometimes state and local governments are susceptible to the "herd instinct," that they tend to adopt a tax that is widely used in other states.

There are, however, a number of practical considerations that play a role in the evolution of state-local business tax systems. These include: (1) distribution of the tax burden, (2) revenue productivity and tax neutrality, (3) responsiveness to economic growth, (4) ease of administration and compliance, (5) stable fiscal environment, (6) ratio of business to nonbusiness taxes, and (7) "exportability" of taxes.

The factors mentioned above are all valid considerations in developing both business and personal tax structures for a state. If uniformity, nondiscrimination, and the maintenance of a good business climate are viewed as appropriate objectives, there are several additional criteria that have merit. These criteria are not necessarily valid for all states because of differences in state economies, fiscal conditions, and political environments. The following provide a framework, however, for a good state-local business tax system.

- (1) *A business tax system should be broad based with some consideration of ability to pay.* To ensure that all businesses make some contributions for state services, a broad-based measure of the economic activity of the firm such as value added, rather than profit, could well serve as the primary basis for state taxation of business firms; however, to protect low-profit firms (particularly small businesses) from the excessive tax burdens that can arise from indiscriminate use of business activity or value-added type taxes, appropriate safeguards can be used such as tax credits for low-profit firms, to assure some consideration of ability to pay.
- (2) *The tax structure should be applicable to all forms of business organization.* To ensure that business taxes are borne as equally as possible by all segments of the business community, the business tax system should not discriminate on the basis of the form of organiza-

tion, i.e., sole proprietorship, partnership, or corporation.

- (3) *It should provide immediate write-off for capital investment and dispense with special tax inducements.* To provide equitable treatment in the design of tax policies aimed at encouraging economic development, the immediate "expensing" of business capital investment for all firms is preferable to the granting of special tax concessions that often discriminate against existing firms. This approach should not be interpreted to preclude the selective use of financial incentives when they are a critical factor in an important business location decision.
- (4) *The number of separate taxes within a business tax system should be kept as small as possible.* To minimize compliance and administrative costs for both taxpayers and tax administrators, it is preferable to avoid an excessive variety of business taxes.
- (5) *A stable tax base should be used.* To provide a uniform flow of business tax receipts, policymakers should use a measure of business activity that remains relatively unaffected by swings in the business cycle (e.g., value added rather than profits). As mentioned above, however, some safeguards should be built in to protect small, low-profit firms.
- (6) *States should provide funding to local governments to allow local repeal of personal property tax on inventories.* The property tax on inventories is a discriminatory, unstable, and difficult to administer tax that encourages uneconomic behavior. The use of this tax should be avoided if possible. Most local governments, however, could not afford to repeal the tax without replacement revenue from other sources. ACIR has recommended that the states eliminate the tax on business inventories and either move the administration of the tax on other classes of business personal property to the state level or provide strong supervision over its administration to ensure uniformity.<sup>5</sup>
- (7) *Rates should be moderate for unemployment insurance and workers compensation as well as for general business taxes.* Rates for general business taxes as well as for unemployment insurance and workers compensation should be competitive with other states in the

region. Unemployment insurance and workers compensation usually are overlooked in discussions of business tax policy but often are a larger cost item for business than general business taxes. High rates can have a negative effect on a state's business climate. It is difficult to make state comparisons for these insurance costs because rates depend on experience (with layoffs), ratings, court rulings, injury rates, and other complex factors. A state, however, easily can determine if its rates are well above or below rates in other states.

### *Excise Taxes*

Excise taxes on alcohol, tobacco, and motor fuel are relatively minor sources of revenue for most states. Exceptions are New Hampshire, which collects 28.1 percent of its tax revenue from these sources, and most southern states, which raise from 15 percent to 18 percent of tax revenue from this source. Nationwide, these taxes account for less than 10 percent of all state-local tax revenues. These revenue sources can be important, however, because they usually can be increased with a minimum of political opposition and are productive enough to meet small budget shortfalls—a convenient chink filler. Since 1980, almost every state has increased one or more of these taxes.

Excise taxes have three major disadvantages. First, they have very little growth potential; nationwide, revenue from these taxes increased only 9.6 percent between 1979 and 1983, despite numerous rate increases. Second, they are regressive, falling more heavily on low-income persons than high-income persons. Third, they are susceptible to tax evasion. In the 1970s, cigarette smuggling was a particularly serious problem (states lost 10 percent of cigarette revenues according to a 1975 ACIR estimate); and in the 1980s, avoidance of the motor fuel tax has become a major problem.

If states must rely on excise taxes, three actions can be taken to improve their revenue potential.

- (1) *Specific taxes (levied per unit) should be replaced by ad valorem taxes (levied on value).* This action will improve the growth potential of these taxes significantly, as revenues will increase as prices increase. Liquor taxes generally are levied on an ad valorem basis, but



only Hawaii levies an ad valorem cigarette tax. In recent years, a number of states have adopted ad valorem gasoline taxes; this action was prompted by a sharp fall in consumption in response to high price increases in the 1970s.

- (2) *State and local governments should use restraint in setting excise tax rates.* Tax rates that are substantially higher than those in nearby states or communities will encourage tax evasion.
- (3) *When excise tax rates are increased, a share of the proceeds should be earmarked for law enforcement and audit programs.* Because excise taxes are not major revenue sources, many states are reluctant to spend money on law enforcement and auditing. Strong enforcement and audit programs are needed to prevent high levels of tax evasion if state tax differentials are large.

### *Severance Taxes*

In most states, severance taxes are a relatively unimportant revenue source. Nationwide, severance taxes accounted for 3.7 percent of all state taxes in 1984. However, in Alaska (73 percent), Louisiana (28.7 percent), Montana (26.8 percent), New Mexico (30.2 percent), North Dakota (35 percent), Oklahoma (29.7 percent), Texas (25 percent), and Wyoming (52.9 percent), these taxes are a very important revenue source. As a consequence, Alaska has no income or sales tax; Wyoming and Texas have no personal or corporate income tax; Montana has no sales tax; North Dakota, Oklahoma, Louisiana, and New Mexico have sales and income taxes, but with rates lower than most other states.

These taxes are an attractive revenue source because they are largely exported to other states, and natural resources cannot be moved to avoid high taxes. Excessively high tax rates, however, could discourage marginal exploration activities.

### *User Charges*

State and local governments have been increasing their reliance on user charges for more than two decades. Since 1977, there has been an acceleration in this trend, particularly at the local level. From 1957 to 1977, the average annual growth rate in local government user charges was 9.3 percent; from 1977 to 1983, the growth

rate was 13.5 percent. At the same time, the growth rate in taxes declined from 8.6 to 7.1 percent. The most significant increases occurred in sanitation, water revenues, special assessments, and the other public utility category. The recent increase in the growth of user charges suggests that this revenue source, which is not constrained by most state-imposed restrictions on local revenues, has provided an important "escape hatch" for local governments in the post-Proposition 13 era.

In a May 1983 survey of over 500 municipal finance offices, ACIR found that raising user fees was the action most frequently taken to raise revenue, cited by 72 percent of the respondents. After Proposition 13, California increased user fees sharply, from 13.4 percent of own-source revenue in FY 1978 to 19.5 percent in fiscal 1981.

User fees are most common in the Southeast and Far West and least common in New England. Medium- and smaller size cities rely on user charges more than larger cities, because larger cities have more diversified tax structures and provide more public goods not suited to user fees such as welfare and housing. The trend to user charges appears to reflect the preference of citizens. A 1981 ACIR public opinion poll found that taxpayers prefer user charge financing by overwhelming margins compared with other local taxes. About 55 percent supported this method of raising revenue, more than two and a half times the support for the next choice, the local sales tax. There is the potential for increased employment of user charges. Local governments could do a better job of unbundling specific services from general tax financing in areas such as police and fire protection. Local governments could finance a minimum level of service with taxes and charge for higher levels of service. Among the areas where there appears to be plenty of room for additional user fee revenue are special assessments (particularly on building developments) and trash collection.

User charges are likely to increase in importance as a local (and state) revenue source, particularly if President Reagan's proposal to eliminate the federal deductibility of state and local taxes becomes law. This outcome would place user charges on an equal footing with sales, income, and property taxes and could increase the use of fees and charges dramatically.

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## The Balanced Revenue System—Future Prospects

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The movement toward a more balanced state revenue system will be determined largely by what happens to the state personal income tax in general and to the deduction of state income tax payments in particular. If Congress eliminates the deduction of state income tax payments, this action would sharply increase the pressure on states with highly progressive rate structures to move toward more moderate income taxes—a plus for the cause of a balanced tax system.

On the down side, the loss of the deductibility privilege would increase the competitive tax advantage now held by the non-income tax states substantially. It would become more difficult to sell even a flat rate income tax in these states. Why? Because the opponents of an income tax would argue that the adoption of a state income tax would make the state far less attractive to investors. In effect, it would be the equivalent of throwing away the state's number one economic development trump card.

In summary, the case for a balanced state-local revenue system rests on three propositions. First, most states are likely to encounter an increasingly harsh fiscal climate marked by growing interstate tax competition, more cutbacks in federal aid, threats of taxpayer revolts, and great uncertainties about the economy. Second, most states will need to develop some overall revenue strategy that is designed to reconcile the need to reduce state vulnerabilities to this harsh environment while, at the same time, still maintaining an adequate flow of revenue and an acceptable degree of tax equity. Third, a balanced or "middle-of-the-road" state-local revenue strategy appears to be the best way to reconcile these conflicting needs because it calls for (a) moderate use of income, sales, and property taxes; (b) proportional distribution of the tax burden with safeguards for low-income taxpayers; and (c) an equilibrium between the growth of state-local revenues and the growth of the state economy.

The authors of this balanced state-local revenue system also favor an early spring and a late fall.

## Notes

1. There have been some jurisdictional disputes involving collection of commuter taxes from residents of other states, for example, the New York commuter tax. In addition, the imposition of a nonresident income tax on in-state commuters has been a hot political issue in several states.

2. A simple regression of the two variables produced an  $R^2$  of .694 and a high significance level with a T Value of -10.44.

3. A number of states have classified property assessment systems with different assessment ratios specified for different classes of property. For example, Minnesota has 38 different classifications. This approach creates complexity and inequities. As a result, the Minnesota tax study committee recently recommended that the number of classifications be reduced to three.

4. U.S. Department of Commerce, Census of Government, *Taxation of Property Values and Assessment-Sales Price Ratios* (Washington, D.C.: U.S. Government Printing Office, 1982), pp. XLII-XLIV.

5. ACIR, *The Role of the States in Strengthening the Property Tax*, Vol. 1, A-17, June 1963.