Balancing act: Tax structure in the Seventh District

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State and local governments are facing their toughest fiscal situation since the recession years of the early 1980s. As tax revenues throughout the country fall below projections, state and local governments are grappling to find the right course between spending cuts and tax increases. Owing to budget problems of its own, there is little hope that the Federal government can help the states in these recessionary times.

As state and local governments begin to examine their expenditure and revenue options, it would be wise for policy makers to bear in mind what constitutes a good tax system, as well as the major advantages and disadvantages of the tax sources available to state and local governments.

Many analysts have described what they believe the objectives of a good tax structure should be. While the criteria developed share many common concerns, no two lists are exactly alike. Depending on which aspect of the tax structure receives emphasis, goals can conflict and blueprints for tax policy can become muddled. However, keeping well-defined criteria at the forefront can help focus the tax policy debate and can force policy makers to be explicit in recognizing the trade-offs that occur in selecting one tax over another.

This article will begin by reviewing the criteria often cited for establishing a good tax structure. Against these criteria, it will examine the tax structure of the five Seventh District states—Illinois, Indiana, Iowa, Michigan and Wisconsin—focusing on their utilization of the property, income and general sales tax. Finally, it will review the tax options now under consideration to relieve state and local fiscal pressure.

Criteria for judging a good tax structure

Requirements for a good tax structure can be distilled from a large body of analysis and thought.[1] Criteria often include the following:

- The distribution of the tax burden should be equitable, with everyone paying a fair share.
- Interference with the operation of efficient private markets by taxes should be minimized. In particular, taxes should not distort economic choice by placing excess burdens on individuals.
- Taxes can, however, be used to correct inefficiencies in the private sector in situations where markets do not behave efficiently.
- The tax structure should help stabilize the national economy while providing adequate revenue growth.
- The tax structure should permit efficient and nonarbitrary administration and should be comprehensible to the taxpayer.
- Administration and compliance costs should be reasonable.

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In order to design tax systems, state policy makers often need more detailed guidelines which incorporate strategies specific to state and local government.[2] In this regard, Robert Kleine and John Shannon have developed the following guidelines of taxation.

- Revenue sources for taxation should be diversified. In particular, they should balance the three principal tax bases available to state and local government: income, property and sales taxes.
- Revenue sources should be stable and taxes should be moderate. This includes using broad tax bases with minimum volatility and insuring that expenditures and state revenues grow at consistent and reasonably parallel rates.
- Taxation should be fair and equitable. That is, the tax structure should be progressive enough to protect the lowest income members of society from bearing a disproportionate share of the tax burden.
- There should be state fiscal equalization preventing property tax disparities from creating local fiscal disparities in funding for education and other programs. Specifically, this calls for state government to take a "senior" role in the state and local fiscal system and assume at least 50 percent of the cost for education, health and hospitals, and all of the cost of nonfederal public welfare. In lieu of picking up these costs directly, the state should offer revenue sharing so that communities can fund these programs without sole reliance on the property tax.
- Changes to the tax structure should be politically accountable. Tax increases should be the product of deliberate legislative action and not inherent structural features of the tax system which permit automatic tax hikes. To cite two examples, "bracket creep" for income taxes and changes in assessment practices for property taxes often permit governments to raise revenues without approval from either taxpayers or their representatives. In contrast, indexing income taxes and adopting truth in property tax laws can help safeguard residents from automatic tax increases.
- There should be property tax equity, defined as uniform assessments both within and between towns.
- State and local governments should strive for tax competitiveness. Tax rates and policies should avoid creating an image of a poor business climate. Each state should be cautious that its tax policies do not provide incentives for desired companies to invest in lower tax jurisdictions.

Neither of these lists exhaust the possible criteria for designing a good tax system and it is impossible to meet all of these criteria simultaneously. In trying to meet the goal of one aspect of the tax system, trade offs with other goals are bound to occur; compromises must be made. For example, offering tax incentives to business may undermine revenue stability. Many states have created special tax incentives in order to attract and retain business and to create a "competitive tax climate." In doing so, states narrow the base on their business taxes, often making the revenue performance of the tax more volatile and thereby undermining revenue stability. Similarly, those sales tax policies that exempt "necessities," such as food and clothing, are usually intended to promote tax fairness. In doing so, the revenue stability of the tax system may again be reduced by narrowing the tax base. Furthermore, some of the goals of a good tax system are ill-defined or not universally accepted. Having everyone pay their fair share is a goal of tax equity; however, not everyone agrees on what constitutes a fair share. Should a person's fair share be based on their ability to pay or on the benefit they receive from the public services provided by taxation?

Given that it might not be possible to satisfy all of the objectives listed above simultaneously, the purpose of reviewing lists such as these is to provide the framework for examining what specific needs and pitfalls should be considered when trying to reform or modify a state's tax structure. Revenue systems are reformed because one feature of the system has fallen out of line. Too often, in the process of re-alignment, other important features are neglected.

Currently, revenue adequacy is the one goal of taxation which is of most immediate interest to policy makers. Many states are finding that revenues are not adequate. None of the three major state and local tax bases (property, sales, income) appear to be easy targets for revenue expansion to relieve the currently strained state and local fiscal condition. Yet states are largely limited to the property, sales and income tax bases which have traditionally been the focus of major tax changes.

Seventh District focus

The District's revenue structure

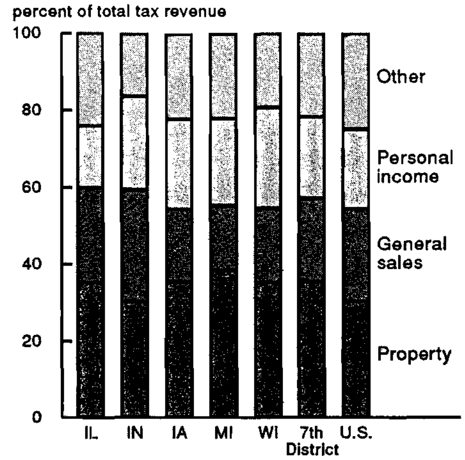
Seventh District states have established a fairly conventional tax structure, raising the bulk of their tax revenues from property, sales and income taxes. District states differ somewhat from the rest of the nation in that they rely on property taxes for a greater proportion of revenue. Income and sales tax bases grew faster during the 1980s than the property tax base. As a result, District tax revenues grew more slowly during the 1980s than the rest of the nation.

The property tax

Table 1 compares the District with the U.S. on property tax reliance. The Advisory Commission on Intergovernmental Relations (ACIR) tax effort index reported in the Table is designed to measure a state's tax effort relative to the U.S. (see Box for details). Table 1 shows that, as measured in terms of effective tax rate, share of personal income and the ACIR tax effort index, District states tend to utilize the property tax more heavily than the national average. It is therefore not surprising that in terms of revenue raised, the property tax comprises the largest share of state and local tax revenues in the District states, as shown in Figure 1.

FIGURE 1

Distribution of state/local tax revenue by source



SOURCE: Government Finances: 1988-89, Bureau of the Census.

Table 2 compares the growth of the property, sales and income tax revenues for District states and the U.S. during the 1980s. From 1981 to 1989, real property tax revenues in the District grew by only 15 percent while sales and personal income tax revenues were up more than 25 percent, in spite of the fact that the District attempts to tax property more vigorously than the other tax bases. At the national level, property tax revenues were the slowest growing revenue source with receipts up 31 percent while sales and income were up 40 and 49 percent, respectively.

TABLE 1

Property tax comparisons for the District and the U.S.

	Effective tax rate* 1987	Share of personal income 1988	ACIR index 1988
Illinois	1.59	3.8	129
Indiana	1.28	3.2	103
Iowa	1.96	4.5	152
Michigan	2.26	4.7	157
Wisconsin	2.27	4.5	147
U.S.	1.16	3.5	100

*Effective tax rate reflects the estimated taxes on a FHA insured single family home mortgage.

SOURCES: *State Policy Data Book 89*, Table D-40, Brizius & Foster. *States in Profile, 1990*, Table D-9, Brizius & Foster. *1988 State Fiscal Effort*, 1990, Advisory Commission on Intergovernmental Relations.

Before discussing the advantages or disadvantages of the relative reliance on property taxes for District states, it is necessary to keep several caveats in mind. It is very difficult to make meaningful generalizations about how the property tax burden uniformly affects any individual state due to the wide variation in local property tax administration. Given the local nature of the tax, the property tax burden can be significantly different from town to town and can reflect differences in the level, quality and efficiency of town services, variation in the local price of providing services, assessment practices,

TABLE 2

Real tax growth by type of tax: 1981-1989
(Percent change)

	Property	General sales	Personal income	Total tax
Illinois	15.6	19.5	19.1	13.2
Indiana	9.7	31.1	109.1	34.9
Iowa	4.7	27.1	20.4	13.8
Michigan	12.8	20.6	29.2	19.5
Wisconsin	30.2	46.2	7.6	25.6
U.S.	31.4	39.9	49.9	32.49
District	15.0	25.5	27.6	19.58

SOURCE: *Government Finances: 1980-81, 1988-89*, Bureau of the Census.

and other factors. Simply noting that the average property tax burden for a given state is high fails to recognize the extremely varied distribution of this tax burden.

Determining the ultimate burden of the property tax is also an issue of dispute. Originally, tax theory held that property tax was passed on to tenants and consumers of property. As such, the effect of the tax showed up in either the tenants' rent or in the price of a property. In practice, this made the property tax regressive with respect to income since lower income households tend to devote a larger share of their income to housing. For this reason, many tax analysts held that reliance on the property tax should be held in check due to its regressive sting.

However, more recent theory has held that the property tax is actually a tax on capital. As such, its incidence is reflected in a reduced return on capital investment which ultimately is also borne by labor. Labor is affected because the reduction in capital stock caused by the property tax reduces labor output. The effect is even more pronounced when there are differentials in property taxes between jurisdictions. Here a distinction must be made between the effect the tax has on land vs. its effect on capital. While land is immobile, capital is not. Consequently, differentials in property tax rates will induce capital to move to locations with lower tax rates, thereby increasing the return on capital. This will cause investment funds to flow out of high tax jurisdictions and into low tax jurisdictions until the return on capital investment is equal in both jurisdictions. This will leave the high tax town with a diminished share of capital stock, which can be a major concern for a town's economic growth and development.[3]

The District's reliance on the property tax probably has little to do with the debate over who bears the burden of the tax. High property tax reliance is usually related to a variety of other factors which relate taxes to the funding of public services rendered rather than to who bears the tax burden.. If there is a political preference for local governments funding a large share of public education expense or other local programs, the property tax burden will be higher. For example, in Illinois, the existence of thousands of special districts and other governments explains why the state's reliance on the property tax is higher than the U.S. average. Also, property tax reliance is often a product of historical factors. Agricultural states tend to rely on property taxes because, historically, the property tax was a good way to relate the tax burden to the ability to pay. In an agrarian economy the more farm land held, the greater the ability to produce income.[4]

Critics often attack the property tax on several grounds. The first criticism is that it serves as a poor proxy for judging an individual's ability to pay the tax if the tax is viewed solely as a tax on the consumption of housing. The property tax is often claimed to be "horizontally inequitable" in the sense that individuals with equal incomes or wealth rarely have an equal property tax burden due to variations in their housing consumption. For example, two houses may be assessed and taxed at identical rates and yet disparities in the incomes of the owners can make the burden of the tax minimal on one owner and heavy on the other. For example, the tax burden is often heavy for senior citizens on fixed incomes who find that property taxes consume a larger and larger fraction of income over time.

Another criticism is that the multiplicity of taxing districts and variations in tax structure often provides incentives for avoiding the tax. In states where mobile personal property such

The Advisory Commission on Intergovernmental Relations Representative Tax System

The Representative Tax System (RTS) was created by the Advisory Commission on Intergovernmental Relations (ACIR) in an effort to allow comparisons of state and local tax capacity and effort between states. RTS measures the amount of revenue that would be raised if a state applied national average tax rates to 27 different tax bases within the state's boundaries. The figure arrived at through this process defines the hypothetical tax capacity of a given state. It is important to note that the RTS is a hypothetical measure that assumes all states utilize all 27 tax bases and that all states tax at the same rate.

Tax effort in the RTS attempts to determine a state's relative utilization of its tax base. Tax effort is the ratio of actual state tax collections to the state's hypothetical tax capacity. A tax effort above 100 indicates that the state's utilization of the tax is above the U.S. average. For example, Wisconsin's 1988 tax effort score for the personal income tax was 157. This indicates that the state imposes a tax burden which is 57 percent above the national average. Conversely, a score below 100 indicates that the state's utilization of the tax is below the U.S. average. For example, Michigan's sales tax effort of 76 means that the state's sales tax effort was 24 percent below the U.S. The RTS provides a basis for standard comparisons among states.

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as automobiles is taxed, there is an incentive to register cars in towns with low tax rates even if the owner resides in a higher tax town. A further criticism is that gaps in the property assessment cycle can distort the relative value of both personal property and new construction, forcing both to bear an unfair share of the tax load. This occurs when personal property and new construction assessment reflect current value while real property assessments are allowed to lapse for several years in between revaluations. In some states the gap between real property revaluations can be as much as 10 years.

Evidence suggests that high property taxes can also serve as an obstacle to business and economic development, since the property tax can often be the largest tax faced by a business. A recent Wisconsin study found that the property tax constituted 47 percent of the state and local total tax liability for a group of six manufacturing industries.[5] This out-distanced the corporation business tax which comprised 35 percent of total state and local tax payments. The view that high property taxes impede economic development is supported by economic theory, which holds that differentially high property taxes will tend to increase the cost of capital, thereby encouraging new investment to seek lower tax jurisdictions.

Finally, high property tax reliance can create fiscal disparities between communities. Goals of equity and fairness can be undermined when property poor towns are forced to provide the bulk of their local services through the property tax.

The primary defense of property taxation tends to be founded more on political than economic grounds. Because property tax growth is relatively inelastic, or unresponsive to swings in economic activity, it supplies a steady but sluggish revenue source for local governments. This steady growth can be a stabilizing factor for local governments in bad economic times.

The relative stability of the property tax has proven to be an advantage during the recent recession. National Income and Product Account data placed the property tax as the fastest growing revenue source when measured from the first quarter of 1990 to the first quarter of 1991. Specifically, property tax revenues have grown by 6.5 percent while sales and income tax revenues have increased by only 2.7 and 3.8 percent, respectively. Recessionary effects which are impacting sales and income tax returns are less likely to cut into property tax gains. Since property tax assessments often lag because of administrative features, this tax source continues to grow as updated assessments reflect past gains in property values even though current values may have stabilized or declined. This administrative lag can often stabilize government spending in the early periods of a recession and generally reduce reliance on faster growing but more volatile tax bases such as income and sales.

In summary, the District's reliance on property tax suggests a choice of slower but more stable revenue growth, more costly investment in property from a tax perspective and an overall tax structure that is probably more regressive with respect to income than is the case for the U.S. as a whole. Further, while the property tax may have the advantage of increasing local government accountability by requiring that more services be performed at the local level, it reduces the redistributive role of state government by reducing the potential revenue raising capacity of state government.

The general sales tax

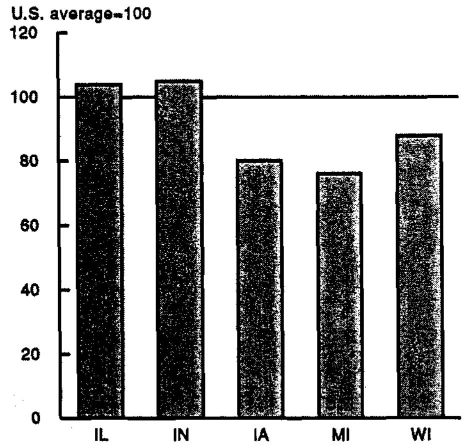
District wide reliance on the sales tax varies significantly. While both Indiana and Illinois draw 25 and 29 percent of total state and local revenues from the sales tax, the remaining three District states all draw less than 20 percent. This variation is also evident in the relative burden of the tax as a percentage of personal income. In Indiana, the sales tax is 3.1 percent of personal income, in Illinois it is 2.6 percent and in Wisconsin it is 2.5 percent. In Iowa and Michigan the percentage falls to 2.1 percent. When viewed relative to the U.S. average, only Indiana exceeds the national figure of 2.8 percent. This variation occurs despite the fact that state sales tax rates among the five District states are quite similar, ranging from 4 percent in Michigan to a high of 6.25 percent in Illinois.[6]

The significant difference in reliance has come about because states differ in authorizing localities to levy their own sales tax. Iowa, Illinois and Wisconsin all permit other governmental units to levy a sales tax in addition to the basic state sales tax rate. In Chicago, for example, the total sales tax rate levied by all overlapping governments is 8 percent. Meanwhile, just over the state line in Indiana, the rate is 5 percent. Such disparities can create an incentive for people to avoid additional sales taxes by crossing state borders to make purchases.

Even in the ACIR tax effort figures, District states rank very low nationally on the sales tax effort index (see Figure 2). Only Indiana and Illinois at 105 and 104 respectively are above the national average. When compared to the very high property tax effort scores for

FIGURE 2

Sales tax effort: 1988



SOURCE: 1988 State Fiscal Capacity and Effort, August 1990, ACIR.

District states, it is clear that the District provides something of a break with respect to consumption taxes. This reduced reliance does not arise because of any smaller tax base in the District. Rather, it most likely reflects differing exemption policies for certain goods (all five District states exempt manufacturing machinery and materials as well as food and prescription drugs from the sales tax) rather than lower spending tendencies by District residents.

Low reliance on the sales tax is perhaps the most unusual aspect of the District's tax structure. Nationally, the sales tax is consistently seen as the most popular tax in surveys of taxpayers. Much of this popularity is due to administrative features of the tax. The relatively small amount of the tax attributable to the purchase price of a good makes the tax less visible on all but the largest purchases.

In addition to its relative popularity, the sales tax is fairly easy to administer even though sales tax audits are necessary and often expose significant fraud. The sales tax also has the added advantage of being an exportable tax in that it is paid by those nonresidents such as tourists and conventioners who make purchases within the state.

One problem often noted with the sales tax is that it is not progressive. That is, if a wealthy person and a poor person buy the same good, the tax bite as a share of income is much greater for the poor person. Attempts to correct this feature and reduce the regressivity of the tax by exempting food and other necessities often fail because the tax break tends to provide relief to both income groups. As a further drawback, exemptions of necessities, such as food, increase the volatility of the tax base by making the base more reliant on "big ticket" consumer goods such as cars.

Further, the relative regressivity can be capricious, because it is greatly influenced by an individual's particular consumption and savings habits. This feature is moderated to some extent because it is possible to escape some of the sales tax burden by lowering the level of consumption and increasing savings. Indeed, some analysts favor this tax because it encourages national savings. But low income individuals have much less latitude in their consumption vs. savings decisions. Much of the decision to consume is based on the relative need for a product. The more price inelastic the demand for a product, the more regressive the sales tax. For goods that are price elastic, such as luxuries, the seller of the product may have to absorb some of the tax burden.[7] Necessities are relatively price inelastic, consequently the buyer must absorb all of the tax burden.

By underutilizing the sales tax, District states generally forego revenues from the least politically objectionable tax source. Their gain may be greater revenue stability because they are less reliant on this relatively more volatile base. Furthermore, by permitting local sales taxes, the states provide local governments with an option for revenue diversification which can lessen the dependence on the property tax. However, taxpayers find it easy to avoid the local sales tax by making purchases in lower tax jurisdictions, thereby affecting shopping location decisions.

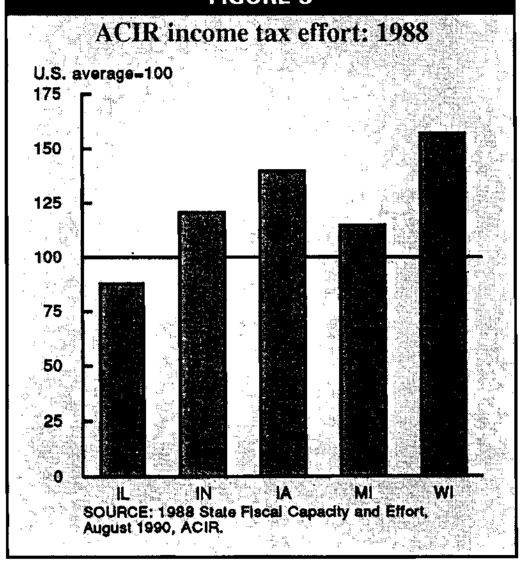
The personal income tax

The District tends to be slightly above the national average in utilizing the personal income tax. When measured as a share of state and local revenues, the District tends to draw on the personal income tax more heavily than the U.S. as a whole. This is also reflected in the burden of the personal income tax as a percentage of income. The U.S. average for state and local personal income taxes as a percentage of income is 2.1 percent. District states above the average include Indiana at 2.3 percent, Michigan at 2.5 percent, Iowa at 2.6 percent and Wisconsin at 3.3 percent. Only Illinois at 1.7 percent is significantly below the average.

With the exception of Illinois, with its low reliance on the personal income tax (this will change given the recent tax surcharge which raised the income tax rate from 2.5 to 3 percent), the District tends to conform fairly closely to the ACIR criteria of raising a quarter of revenues from this source. However, it does so by imposing a slightly higher tax burden on residents relative to the nation. Both the tax as a share of personal income numbers and the ACIR effort index reflect a relatively high burden for this tax (see Figure 3).

Differences in reliance among District states arise primarily from differences in the tax structure. Three states—Illinois, Indiana and Michigan—have flat rate income taxes which range from 3 percent in Illinois to 3.4 percent in Indiana and 4.6 percent in Michigan. Iowa and Wisconsin have graduated rate income taxes, with Iowa's tax consisting of nine tax brackets ranging from a tax rate of .4 percent to 9.98 percent, and Wisconsin's consisting of three brackets ranging from 4.9 percent to 6.93 percent. All five states use some variant of federal adjusted gross income as a starting point for the tax base. As a group, none of the District states can be characterized as having generous deductions or tax credits in arriving at state taxable income. Both Illinois and Indiana permit only a $1,000 standard deduction against individual income before levying their flat rate tax. Iowa and Wisconsin provide limited tax credits.

FIGURE 3



Iowa's credit is $20 for the filer and $15 for each dependent while Wisconsin limits its tax credit to $50 per dependent. Michigan provides the most generous standard deduction at $2,000. The impact of these limited deductions and credits is to make the income tax more regressive in District states, particularly in those with low standard exemptions and flat rate tax structures, than in those states with progressive rate tax structures or large personal exemptions.[8]

There are several advantages to raising revenues through income taxes. It is considered the best tax in terms of progressively relating the tax burden to one's ability to pay. And assuming that the tax uses a fairly broad measure of income, it is also horizontally equitable, that is, it treats equally-situated individuals the same. Tax compliance costs are also lessened through conformance with the federal income tax base guidelines. The tax is highly productive as a revenue source. As personal incomes rise the tax base grows. As such it can provide a substantial revenue source for the states. Also, because most states choose not to index the income tax base, state income tax revenues can grow through bracket creep in which increases in personal income push tax payers into higher tax brackets even if their inflation-adjusted incomes have not increased significantly. Since three of the District states utilize flat income tax rate structures, bracket creep is less of an issue within the District.

One disadvantage of the personal income tax is that as it reduces disposable income, it can serve as a drag on spending and investment. A relatively higher income tax burden can mean that people will adjust their spending and savings habits in order to absorb the tax. This behavior is likely because the income tax in most cases cannot be transferred or shifted to another party. As such, the District's slightly heavier burden on income taxes may tend to reduce both consumption and savings. Furthermore, the preference toward flat tax rates with limited deductions erodes much of the progressive structure usually associated with income taxes.

Exportability

Tax exportability—the ability to levy taxes in such a way that the burden is borne by out-of-state residents—is quite understandably a desirable goal from the point of view of the state levying taxes.[9] The advantage for a state in having a significant share of its tax base exportable is that it lessens the tax burden on state residents. Three states noted for having highly exportable tax bases are Alaska, Nevada and Hawaii. Alaska is able to export a great deal of its tax burden through severance taxes on the sale of oil. Because oil deposits are mostly owned by large multi-national companies, which are in turn owned by non-Alaska residents, severance tax incidence falls on out-of-state residents. A 1980 study[10] found that Alaska was able to export 36 percent of its tax burden largely because of the severance tax. The same study found that Nevada was able to export over 20 percent of its tax burden through the sales taxes on gambling by out of state residents. Hawaii exports taxes by taxing spending by tourists.

By comparison, Seventh District states are not so blessed. At present, there is no large industry generating profits for out-of-state residents which can be tapped by the tax system. Very little of existing revenue vehicles are able to export the burden. This is due in part to the District's relatively heavy reliance on property taxes, which are usually not exportable, and the light reliance on sales taxes, which are the most exportable. The 1980 study found that while the average rate of tax exportation for the U.S. was 9.6 percent, the range in the District states was 7.7 percent in Illinois, 6.5 percent in Michigan, 5.8 percent in Indiana, and 5.4 percent in both Iowa and Wisconsin.

In a sense, taxes can also be exported to the federal government when states take advantage of the so-called federal offset permitting deductions from the federal income tax for selected taxes paid to states and municipalities. In particular, income and property taxes are currently eligible as a deduction for those who itemize deductions on federal returns. District states fare better with respect to federal tax exportation because they rely heavily on property and income taxes. In 1980, the national average for the federal offset of state taxes was an estimated 7.1 percent. Among District states, the value of the offset was greater in all states except Indiana; 7.5 percent in Illinois, 5.6 percent in Indiana, 7.3 percent in Iowa, 9.2 percent in Michigan and 10.2 in Wisconsin. Sales tax deductions were phased out following the 1986 Tax Reform Act and are no longer a source of federal tax exportability. With the elimination of sales tax deductability, the size of the offset has undoubtedly declined but, given the District's lesser reliance on sales taxes, the decline has probably been less precipitous than in high sales tax states.

One final trend which also affects the relative value of the federal tax offset is the recent popularity in state and local governments of user fees and special charges. While these have the advantage of diversifying revenue sources and directly relating the cost of providing a service to the beneficiary, they have the disadvantage of not being deductible from federal taxes. User fees and charges often replace revenues from deductible sources, such as property and income, which in turn reduces the value of the federal offset.

Options for raising tax revenues

States are now facing the largest revenue gap since the 1981-82 recession. Then, most states initially tried to avoid major tax increases. Nevertheless, states entered FY83 with record tax increases. At the beginning of FY83, 16 states raised their income tax, 11 raised their sales tax and 5 raised both. Furthermore, 10 states had a stated goal of trying to increase revenues by 15 percent that year.[11]

While states are today looking at similar options, fears of developing a less competitive tax climate than neighbors have many states attempting to raise revenues through means other than raising major tax rates. Some states, motivated by their current fiscal problems, are reducing tax rates that are perceived as being too burdensome, and replacing these taxes with new ones. For example, Tennessee and Connecticut considered instituting state income taxes and using the money raised to role back the sales tax rate. In Tennessee's case, the state sales tax rate could be cut from 5.5 to 4 percent and in Connecticut from 8 percent to 4.25 percent. The belief is that a more balanced tax system will ultimately be of greater benefit to the states' residents while also enhancing economic development.[12]

In a turnaround of trends from the 1980s, a number of states with progressive rate income taxes are considering raising the top marginal tax rate on individual income taxes. Proposals to do so have been offered in California, Delaware, Montana, Maine, and New York. For example, a legislative package in California proposed raising the top bracket marginal tax rate from 9.3 to 11 percent. While these proposals have received some popular support, others have criticized them on the grounds that higher income individuals tend to be more mobile, so that high marginal rates may encourage the wealthy to leave, thereby diminishing the tax base.[13]

The sales tax is the remedy most frequently considered by states to relieve fiscal pressure. Two kinds of changes are being considered. Rather than increasing the tax rate, most states are looking at ways to eliminate tax exemptions for certain items such as snack food and magazines, thereby broadening the tax base. California recently added a number of snack foods to its sales tax base, although problems defining what constitutes a snack food are being encountered. Alternatively, states are considering an extension of the sales tax base to include services. Service taxation is still an area where states have been moving cautiously. A broad-based taxation of services has yet to emerge although certain professional and personal services are increasingly being taxed.

Service taxation has been defended on several grounds. According to one argument, the purchase of services is a form of consumption just like the purchase of tangible property. There is no reason to treat the choice of one type of consumption differently from another. Consequently, according to this argument, service taxation is a matter of tax equity as well as neutrality. It is unreasonable to penalize those who consume tangible goods rather than services, thus encouraging service purchases rather than goods.

As a practical matter, services have not been taxed because of difficulties in administering the tax. Because some services, such as housekeeping and lawn cutting, are very informal, it is difficult to imagine that a tax on such services could be easily imposed and easily collected. However, other services, particularly those involving the repair and maintenance of tangible personal property, are particularly vulnerable targets for sales taxes. Subscription services such as cable television are also a frequent target for the same reason. From a practical point of view, service taxation is not without advantages. The rapid growth in service activities and in service consumption makes this a particularly attractive potential tax base. Increased service taxes can broaden and reduce the volatility of sales taxes which have grown dependent on big ticket durable goods purchases.

Objections to service taxation are based on the fear that this is such a huge pool of revenue that it will not only relieve current fiscal pressures, but further encourage government spending. Another objection is that service taxation should not apply to many of the services purchased by business because this would be a form of double taxation, i.e. the physical output (which embodies the service) is ultimately taxed once it is sold. According to this argument, just as most states try to limit taxes imposed on parts used in the manufacturing process to avoid double taxation, services used by businesses should receive similar treatment. Finally, perhaps the strongest objection is based on tax competitiveness. States are very sensitive about taxing those services that are perceived as footloose. Such taxation might also put home state service companies at a competitive disadvantage when competing against out-of-state businesses.[14]

One final area that is receiving considerable attention (but limited action) is property tax reform. Several states (for example, Illinois, Michigan and Kansas) have proposed reducing property tax burdens using either tax caps or roll backs in property assessments.[15] While these proposals are popular with voters—Michigan voters will again try to put an initiative on the 1992 ballot to roll back assessments by 20 percent—cash strapped state governments have trouble identifying sources of funds to replace these lost local revenues.

The consequences for tax reform measures

When examining the tax structure of a given state or local government it is important to realize that the effect of raising $100 million in revenues through an increase in the sales tax is not the same as raising 100 million through the income tax. For District states, concern about revenue sources is increased by the tight fiscal situation facing its governments and the resulting adjustments to state fiscal systems.

In recent tax developments, many of the District states have attempted to reduce dependence on property taxes. Wisconsin has passed property tax relief measures and Illinois has increased its personal income tax in order to pay for a larger share of education spending, thereby reducing the need for the local property tax to fund these expenditures. Furthermore, Illinois has considered capping property tax assessment growth at 5 percent per year. Michigan's new governor proposed raising state sales and/or income taxes in order to reduce property tax dependence. If the trend to reduce property taxes continues, the result will be a larger role for state government in the District.

In the short run, if District policy makers are forced to raise revenues, they need to consider the tradeoffs suggested by the varying theories of taxation presented here. If a state's interest lies in sparking capital investment, then encouraging increases in local property taxes is probably a bad idea as such a measure could, if unaccompanied by services benefitting local business, increase the cost of capital. If, on the other hand, legislators want to increase tax stability, then broadening the tax base of the sales tax by reducing exemptions or taxing services could provide a valid avenue. In any case, the ability to export tax burden outside the state's boundaries is another consideration. Given the tenuous position of state and local economies, revenue raising decisions must be made with care. Adjusting the tax rates of major revenue sources in an ad hoc manner fails to recognize the interaction between taxes and economic activity. District policy makers need to understand both how the current tax structure effects the economy and how proposed changes may improve or hinder future economic activity.

FOOTNOTES

[1]See Musgrave and Musgrave (1976), pp. 210-211.

[2]See Kleine and Shannon (1986), pp. 33-36.

[3]For more on the incidence and theory of the property tax see Phares (1980), P. Mieszkowski (1972), and Musgrave and Musgrave (1976), Chapter 19.

[4]See Fisher (1969), Chapter 4.

[5]Wisconsin Department of Revenue (1990).

[6]The Council of State Governments (1991), Table 6.17. Note also that the Illinois state government only collects sales tax revenues based on a fixed tax rate. Revenues