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12-15-1979

# Revenue Sources for State and Local Governments: Criteria for Choice

Philip Favero  
*South Dakota State University*

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## Recommended Citation

Favero, Philip, "Revenue Sources for State and Local Governments: Criteria for Choice" (1979). *Department of Economics Staff Paper Series*. Paper 3.  
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REVENUE SOURCES FOR STATE AND LOCAL  
GOVERNMENTS: CRITERIA FOR CHOICE

by

Philip Favero\*

Economics Staff Paper Series No. 79-3\*\*

December, 1979

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\* Assistant Professor of Economics.

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2nd DRAFT

Revenue Sources for State and Local Governments:  
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## Introduction

Citizen dissatisfaction with taxes is a theme which has recurred often in American history--from the Tea Party at Boston to Proposition 13 in California. As before, tax dissatisfaction in its current form is prompting changes in: the level of government expenditures; the mix of revenue sources used to finance expenditures; and the structure of institutions created to provide public services.

Much of the local tax reform effort is focused on state and local finance systems and especially on the real property tax. Citizen participation in reform efforts is an example of democracy in action. Yet, the quality of reforms achieved will depend upon how knowledgeable the reformers are. Frustration and anger will result if tax reforms create unexpected and undesired consequences.

This paper is designed to provide an overview of state and local government revenue options for citizens and public officials. The information is designed to assist in decisions concerning what mix of revenues state and local governments can use and the likely consequences of their revenue choices. Some tests or criteria for choosing among revenue options are defined. Various revenue options are then identified and the criteria are applied to those options.

### Criteria for Choosing a Revenue Mix

Both state and local governments differ among themselves in ways they use to provide revenue. Differences arise because each state and locality is unique in its political, social, and economic characteristics. The size, source, and distribution of incomes differ. Citizen values about the public sector differ. Size and power of interest groups differ. Such characteristics, moreover, evolve over time. That mix of revenues which a community decides is appropriate for one year may not be appropriate the next year.

Thus, for each time and for every unit of government, when the question "which revenue mix to use?" arises, a unique policy problem arises. It is possible, however,

to identify a general set of criteria by which comparisons among the various revenue options may be made. These criteria afford decision-makers the ability to predict the consequences of choosing a particular mix of revenues and to evaluate those consequences. A list of criteria and the test questions they suggest follow:

1. INCIDENCE. Who ultimately would bear the revenue burden? Can a taxpayer who bears the initial impact shift the burden onto someone else?
2. NATURE OF THE BURDEN. How would the burden fall according to income groups? Can the revenue source be characterized as "regressive" (one that takes a greater percentage of the income from lower income groups than from higher income groups) or "progressive" (a revenue source that takes a greater percentage of the income from higher income groups than from lower income groups)? Would the burden fall equally among all family units within an income group?
3. BEHAVIORAL INCENTIVES. Would the revenue source influence consumer behavior; if so, would the change in behavior be desirable? Would the revenue source influence business decisions such as the decision to locate in a certain place?
4. ADMINISTRATION. Can the revenue be collected in an open and observable way? How expensive would the revenue gathering effort be?
5. IMPACT OF INFLATION AND CHANGES IN INCOME. How do inflation and changes in income affect the value of bases of various revenue sources (wealth, income, and consumption)?
6. MACROECONOMIC EFFECT. Macroeconomics is the study of aggregate economic conditions such as inflation or unemployment. The relevant question for this criterion is would the revenue source influence such macroeconomic conditions?
7. BENEFITS RECEIVED. Would those who pay for public services receive the benefits of those services?

#### Revenue Options

Among the various revenue sources available to state and local governments, five taxes and one additional revenue source are common options for a revenue mix. The five taxes - those levied on property, personal income, corporate income, sales,

and particular commodities, and the one additional revenue source - user charges, can be examined and judged according to the criteria for choice.

### Property Tax

The property tax, an example of a wealth tax, was in previous times a major source of state as well as local revenue. Now, the property tax constitutes the predominant local tax, contributing eighty percent of local tax revenue and about one third of all revenue for local governments; but it has become much less important at the state level. Actually, there are several subtypes of property tax, since it may be levied on real property (land and improvements fixed to land), tangible personal property such as household furnishings, and intangible personal property such as the title to common stock.

### Consequences of Inflation

Market values of real property have increased significantly during recent years of inflation. Thus, if officials' assessments of real property values kept pace, the base for real property taxes increased significantly also. Inflation, the general and persistent rise in prices, affects costs of government, however, as well as potential revenues to government.

Table 1 was prepared by Greytak in a study on the net effect of inflation on state and local revenues. Greytak considered the impact of inflation on both: potential revenues created by increased values of real property, sales, income, and other tax bases; and costs of purchases by state and local governments. The net effect of these two opposite forces he termed "purchasing power."

Greytak's general conclusion is that if increased property values were being assessed as such, those units of government which utilize the property tax extensively fared relatively well in recent years. For example, the purchasing power of school districts would have increased by 105.15% during the period 1974-1976 if assessments had increased to reflect increases in market values for real property.

Table 1

Purchasing Power Indexes for State and Local Government  
Revenue Bases, Selected Periods, 1967-1976<sup>a</sup>

	1967-1972	1972-1974	1974-1976	1972-1976
States	90.59	92.98	98.04	91.12
Counties	92.43	93.06	98.04	94.88
Municipalities	91.39	92.03	101.03	92.96
Townships	92.51	91.40	101.11	92.37
School Districts	94.32	95.36	105.15	100.00
Special Districts	89.89	90.14	96.64	87.16
All State and Local	91.54	93.30	99.00	92.44

<sup>a</sup>Excludes intergovernmental aid. SOURCE: Greytak (1978).

Greytak's conclusion on purchasing corresponds with earlier findings by Greytak and Jump which showed that during the period 1967-1972, the potential for increased revenues for local units of government through the property tax was 134.5%. That figure compares with 125.2% potential growth in state and local sales taxes revenues and 134.8% potential growth in state personal income tax revenues for the same period.<sup>1</sup>

#### Incidence and Equity Questions

Another criterion for judging among revenue sources is incidence, or who will pay. Incidence of the property tax will vary. For example, owners who occupy their homes will absorb a reduction in income from a property tax on their residences. Likewise, landowners who hold land property when a tax is imposed or increased will bear the tax either through periodic tax payments or a lower capitalized value at the time of sale. But landlords may share the tax with renters, depending, in part on the market for rental units. Businesses may shift none, some, or all of

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<sup>1</sup>Greytak and Jump (1975).

the tax forward into customers, depending again upon market conditions and upon degree of capital intensity.

When judged according to equity criteria, the property tax is often found wanting. The tax is generally regressive relative to current income and can place a substantial burden on those with the lowest income--especially in a period when real income falls substantially (and the tax liability remains unchanged). A property tax does not necessarily correspond with benefits received by taxpayers, although some services, such as local fire and police protection, are obviously related to property.

Fairness of the property tax is also dependent upon assessment procedures. Quality of assessment may differ among taxing units and even within such units. Moreover, actual differences in property wealth among units create unequal ability to bear the cost of providing local public services, thereby depriving some citizens of services. Those children unlucky enough to be born in property poor taxing units may be deprived of equal educational opportunities.

Several behavioral implications result from the property tax because of economic incentives created by its enactment. Improvements on land and repairs to property are discouraged. Housing ownership for the poor is discouraged in that offsetting income tax deductions for property taxes are not possible for those with very low incomes. Work effort is, however, encouraged.

Several reform proposals have been suggested to improve the tax. Additional state assistance to improve administration is possible and perhaps desirable in some states. Exemptions and credits may be used to reduce or eliminate the regressivity of the tax, and tenants may be recognized as tax bearers in such methods. Replacement of the tax on land and improvements by tax on land only (site value taxation) has been advocated as a way to reduce land prices, reduce idle land in speculation, eliminate disincentives to make improvements, and increase equity by taxing landowners who gain from "unearned increments."

While the property tax has been roundly criticized, it remains a stable and the major source of income for local governments. Severe reductions in the property tax are likely to result in changes in state-local relations, with more local dependence on state revenues. More state involvement (and less local control) is likely. Or, if state replacement revenues are not forthcoming, severe reductions in services, especially school services, are quite probable.

#### Personal Income Tax

Personal income taxes yielded 24 percent of state tax revenues in 1975. Local units of government received four percent of their tax revenues from personal income taxes in the same year.

A tax on personal income may be levied on two kinds of personal income, and therein lies a problem: what should be considered income for tax purposes? Income may be defined first as a current flow of real goods and services available to an individual or taxing unit during a period of time. Or, income may be defined as an accrued net addition to an individual or taxing unit's capital, in the absence of consumption.

According to the flow definition, capital gains would not count as income. According to the net addition definition, such gains would count. Other ambiguities arise in the treatment of income saved, and in the treatment of bequests and gifts.

Even with this ambiguity of what constitutes income and the difficulty in handling immeasurables such as home produced goods, the personal income tax generally receives high marks. Its basic strength lies in equity considerations.

Because income (defined either as current flow or accrued capital) is the primary determinant of economic well-being, the personal income tax can be tailored closely to match ability to pay. Lowest income groups, for example, can be completely excluded from the tax. Adjustments may also be made for circumstances affecting tax capacity, such as moving, or medical expenses, or number of dependents. Finally, the personal income tax can be made effectively progressive, and state and local personal income taxes which "piggyback" the federal income tax can, with low

administrative costs, share in this progressivity.

We have previously noted the responsiveness of the personal income tax to inflation. This tax has been criticized for the automatic way rates are increased when nominal income pushes taxpayers into higher brackets. Yet, the tax has also partially offset the decline in purchasing power of tax bases for state and local governments during the recent years of high rates of inflation. Moreover, the personal income tax tends to reduce aggregate consumption, thereby dampening inflationary forces.

Some have voiced a behavioral concern that the personal income tax might discourage work effort, although little evidence exists to support this concern. Neither does the tax distort consumer choices of goods and services by making some goods and services more costly than others.

An emerging debate at the national level is centered on the net effect of the personal income tax on inflation. While the tax tends to reduce aggregate consumption and thereby inflation, it may also discourage investments into capital formation which would increase aggregate supply. Inadequate increases in supply would tend to heighten inflation over time. The net effect of the tax on inflation is, as yet, unresolved.

For state and local governments, however, the personal income tax offers important advantages. It can be used to offset the regressive incidence of sales and property taxes. And, for rural states, it can serve to reduce the burden placed by the property tax on agriculture, an increasingly property intensive business.

#### Corporate Income Tax

The corporate income tax is applied to net earnings of corporations. Currently, this tax is in use in 46 states. Rates are typically in the four to six percent range.

A major, unresolved question about this tax is that of incidence. Who bears the corporate income tax--stockholders, purchasers, or factor suppliers such as labor? Several studies, using different theoretical assumptions, have yielded conflicting answers to this question.

If the tax is not shifted forward to consumers through higher prices, nor shifted backward to labor through lower salaries, then the tax is, in a general sense, progressive. Stockholder distributions tend to be progressive thereby making a tax on dividends also progressive. Much individual variation exists, however, and low income stockholders would bear a heavy tax. If the tax is shifted, it is unlikely to be progressive.

One reason for preserving the corporate income tax, even given its uncertain and possibly regressive nature, is its complementarity to the personal income tax. Without the tax on corporate earnings, a strong incentive would exist to incorporate and then to retain earnings in closely held corporations. Revenue losses would be significant and equity from the personal income tax would be distorted.

Strong political appeal also exists for the tax. Its impact creates the appearance of payment by "affluent corporations." Moreover, at the state level, tax exporting may be possible either onto out-of-state stockholders or out-of-state consumers of taxed products.

Criticisms of the corporate income tax include the following: Income from corporate dividends is taxed more heavily than other income, being subject to tax at both the corporation and stockholder levels. This unequal treatment of dividend income has prompted several reform proposals. Some have also criticized the tax for behavioral incentives it may create to avoid investments. Clear-cut evidence is lacking, however, on the investment behavior created by the tax.

Complementarity of the corporate income tax with the personal income tax and the political popularity of the corporate tax suggest its continued use. The lack of hard evidence on incidence or on behavior created implies a need for economic research on the consequences of the corporate income tax.

#### General Sales Tax

The sales tax is a tax on consumption. State governments are heavily dependent on general sales tax revenues since the tax is the leading revenue producer and is used in 46 states.

As previously noted, value of the sales tax base in the U.S. tends to be less responsive to inflation than either the property tax base or the income tax base. Similarly, growth in real income generally does not increase sales tax revenues to the extent that such growth increases income tax revenues. A one percent growth in real income will effect approximately a one percent growth in sales tax revenue.

Despite the importance of the sales tax to state and local governments, many tax observers consider a tax on personal income preferable to one on consumption. A common criticism of the sales tax arises because it is impossible to adjust finely the tax to personal circumstances without creating other undesired consequences.

Inability to adjust to personal circumstances results in a regressive tax because shifting of the tax from seller to consumer is likely and because non-taxed savings tend to rise relative to income. The tax is also likely to create a heavy absolute burden for the poorest of families.

Attempts to adjust the tax to personal circumstances fall into two categories. Exclusions from the base for prescription drugs, food and clothing are sometimes used. Such exclusions tend to substantially reduce revenues, increase administrative costs, and add to distortions in consumer spending patterns already created by the common exclusion of many kinds of services. Another adjustment is to provide for sales tax credits against the personal income tax. This adjustment can significantly increase the progressivity of the sales tax--especially when a "vanishing" credit, i.e., a credit which disappears at higher income levels, is used. Problems with the credit adjustment arise because of administrative costs increases for: adjusting credits to changing incomes; handling increased tax returns; policing attempts to cheat; and settling interpretive questions about residence. Some deserving taxpayers may also neglect to file for a credit.

Because the sales tax is a tax on consumption, saving by income recipients would tend to increase and resources would thereby be provided for capital investment. Actual investment will depend on the investment function, however, and the sales tax introduces a dampening effect on aggregate demand because of reduced consumption. Long run macroeconomic implications of the sales tax are uncertain.

As its general use suggests, the sales tax is politically popular. Administration is relatively inexpensive; the taxpayer pays numerous, but generally small, tax sums to non-official collectors. Moreover, state governments regard the sales tax as less a threat to economic activity than the personal income or property tax.

Regressivity of the sales tax should be examined within the context of both revenues and expenditures. A sales tax would impose a heavier burden on lower income families than would a progressive personal income tax. So, if the choice of raising a certain amount of revenue is between the sales or the income tax, ability-to-pay considerations suggest using the income tax. Yet, the choice may often be one of utilizing a regressive sales tax or not providing a public service. This latter choice should then involve additional considerations. Would the service itself be of greater benefit to poorer than to richer families; and, would the service exist at all for the poor or anyone else in the absence of a sales tax?

#### Excise Tax

An excise tax is a tax on the purchase of a particular commodity. The tax may be at a specific rate--so much tax per pound or gallon; or the tax may be according to sale price.

Excise taxes are adopted to meet three objectives. A sumptuary excise tax is adopted to influence consumption patterns for such products as tobacco or liquor. Some excise taxes are imposed in lieu of user charges. Examples are motor vehicle license taxes and fuel taxes as charges for highway use. Finally, excise taxes may be adopted to obtain revenues.

Research by Greytak and Jump reveals that during their study period the motor vehicle license tax was unresponsive to inflation. The unresponsiveness applies, in general, to excise taxes imposed as specific rates. Similarly, excise taxes are usually unresponsive to changes in real income.

Students of taxation have offered several criticisms of the excise tax when it is imposed for the purpose of gathering revenue. If nontaxed substitutes for a taxed good are available, consumers will be influenced to shift from taxed to nontaxed goods. An excise tax on cigarettes only, for example, creates the incentive

for consumers to shift to other tobacco products. Such shifts would result, at the limit, in no revenue for government and lost satisfaction for consumers. Some excise taxes may also be regressive as, for example, the tax on telephone service. Finally, policing and administration of excise taxes tends to be expensive as government must oversee the collection of a tax on particular sales.

Sumptuary taxes and excise taxes in lieu of user charges are not, however, subject to the same criticisms. These taxes have the potential for affecting behavior in desired ways. For example, a pollution tax on waste discharges can influence producers to clean-up their operations and consumers to shift to less polluting substitutes. Sumptuary and excise taxes can thus be collectively self-imposed by communities to bring about, if they are well designed, changes in behavior and, thereby, improvements in performance.

#### User Charges

User charges are prices imposed by government for the use of certain services. Such charges are most common for highway use and for services provided by natural monopolies such as telephone or electric power companies. (Natural monopolies exist when technical economies of size are such that more than one producer would cause duplication or waste, e.g., duplication of power or telephone lines. Such economies have often provided the rationale for public provision or for public regulation of provision by a private monopoly. In other cases, competition has been favored and allowed, even at the price of duplication.) Current pressure on the property tax is also likely to influence local units of government to enact additional user charges on a variety of other public services such as parks or educational programs.<sup>2</sup>

User charges have some distinct advantages over general taxes. They allow some consumer choice. When consumption is responsive to price, they can be used

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<sup>2</sup>"Californians Discover Tax-Cut Mania Has A Corollary: Fee Fever" Wall Street Journal Vol. LIX, No. 143, (June 1, 1979) p.1.

to ration scarce services. Moreover, they convey information to public providers about the nature of citizen demand for the service and about the desirability of further public investments in the service. Finally, they create a direct link between payment and use, thereby conforming, at least in part, to the equity test "payment according to benefits received."

User charges are criticized, however, on other equity grounds. They may be quite regressive and can impose a heavy absolute burden on the poor. Moreover, reductions in the consumption of public services on which a charge is imposed may be considered undesirable. For example, the community may desire that all elementary children attend school in order to participate in the socialization-citizen building process. Imposition of a charge would discourage participation in elementary education.

In addition, personal consumption of some public services, including education, health care, and housing, among many others, creates neighborhood or community-wide benefits such as reduced insurance premiums in a healthy society. Reductions in the consumption of such public services would bring undesired community-wide consequences.

Another possible disadvantage of user fees should be noted. Such fees can be costly to collect. In fact, it would be impractical to charge for many services now provided by state and local governments--services such as paved streets or community security provided by police protection.

#### Conclusion

This discussion of the mix of revenue sources for state and local governments provides a brief overview of the topic. Revenue systems for the provision of state and local public services will inevitably change in response to changed conditions in states and localities. The emergence of rapid and prolonged inflation throughout the U.S. is a new condition affecting public expenditures and affecting different revenue bases unequally. As a related consequence, homeowners with fixed incomes may react against a burdensome property tax. A citizen dislike of a certain kind

of tax, for example, the personal property ("liars") tax may emerge, work its way through the political system, and necessitate restructure of the revenue system.

Resolving emerging problems in public revenue systems requires, in part, a knowledge of both the mix of revenue sources and their likely consequences once adopted. Change and choices are inevitable. The quality of our choices will, however, depend upon our willingness to participate, to be open to new knowledge, and to contribute to the learning of others.

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