

Taxes: Paying for Government Services

Kim Rueben

Tax Policy Center

Krueben@ui.urban.org

www.taxpolicycenter.org



State and Local Taxes

- **Introduction/ Why you should care**
- **Summary of State and Local Taxes**
- **Principals of Sound Tax Policy**
- **Political Considerations/TABOR**
- **Conclude**

Introduction

- **Most state/local governments have balanced budget rules**
 - **So if want to provide services, need funds**
- **Federal funds for local governments tightening as entitlements grow**
 - **Presidents budget limits growth in domestic programs**
- **Tax options often limited by rules and possible economic effects**
- **Goal – raise money need with minimal disruption to economy**

States Raise Funds But Local Governments Often Provide Services

2002	Revenues		Expenditures	
	\$billions	%	\$billions	%
Federal transfers	360.5	20.0		
State	761.6	42.2	918.0	44.8
County	161.0	8.9	253.8	12.4
City/Town	280.2	15.5	393.4	19.2
School District	151.5	8.4	361.5	17.7
Special District	91.8	5.1	120.4	5.9

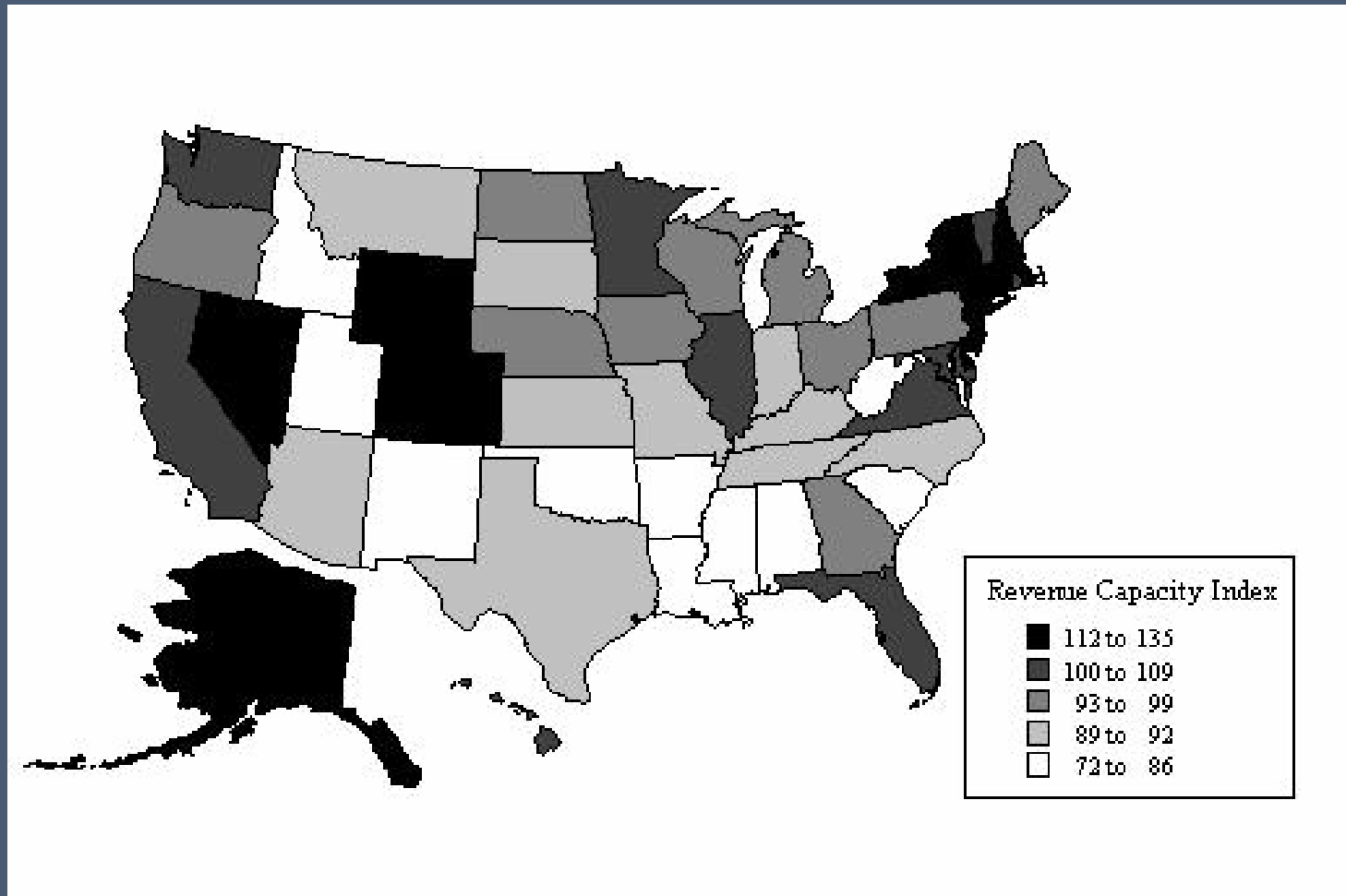
Composition of State and Local Revenues in 2002

Revenue	Share of Own-Source Revenues
Total Taxes	68.3%
Property	21.1%
General Sales	16.8%
Select Sales	7.6%
Individual Income	15.3%
Corporate Net Income	2.1%
Other	5.3%
Charges	19.1%
Miscellaneous Revenues	12.5%

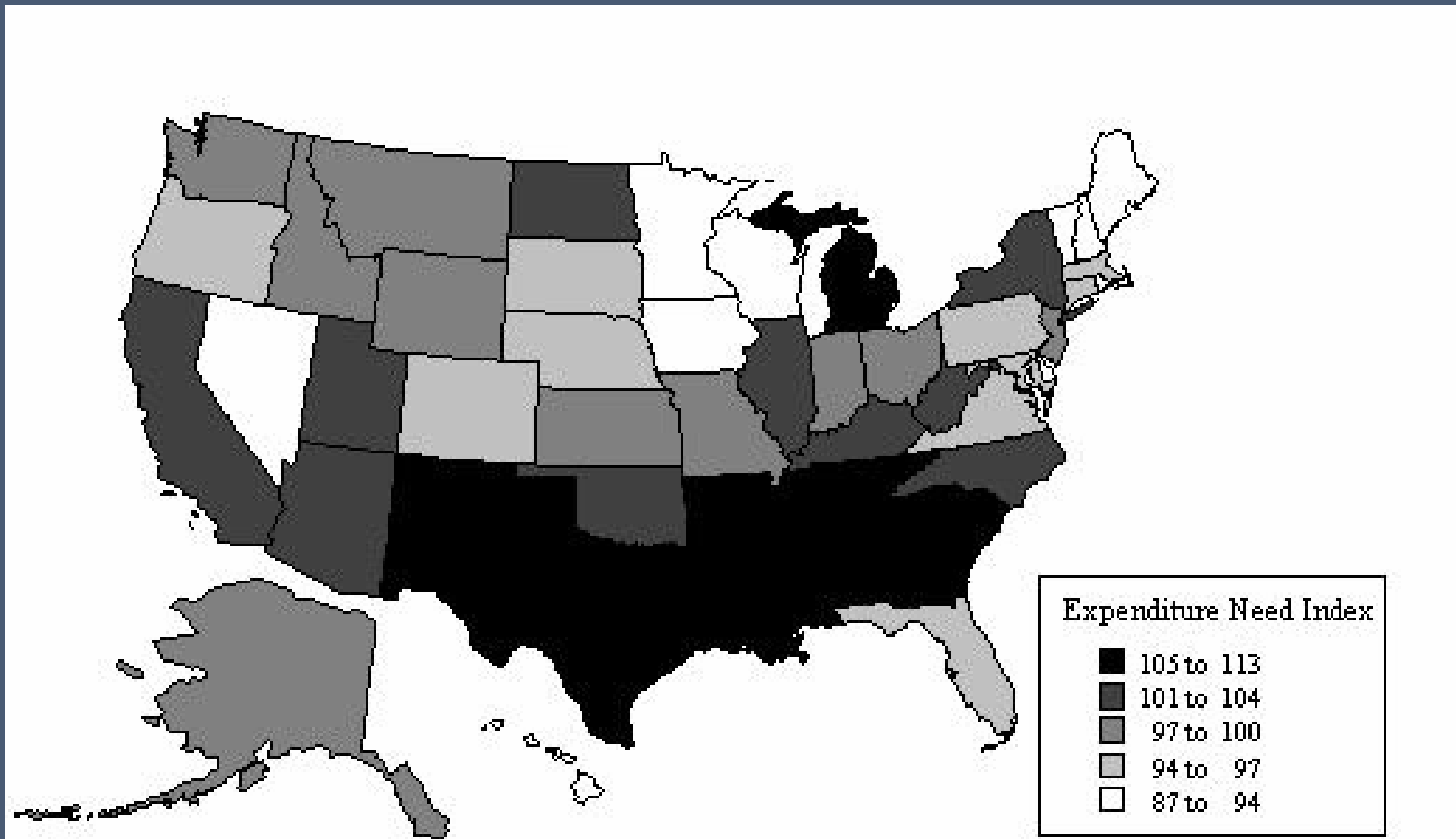
Amount of Services Government Can Provide Limited by Revenues Can Raise

- **TPC/BFR study examines state fiscal capacity**
 - **Abstracts from actual taxes and service levels to show what revenues and expenditures would look like under standard tax/spending system**
 - **Find states with high expenditure need often have low revenue capacity so cannot provide average level of services**
 - **Federal grants don't offset these gaps**

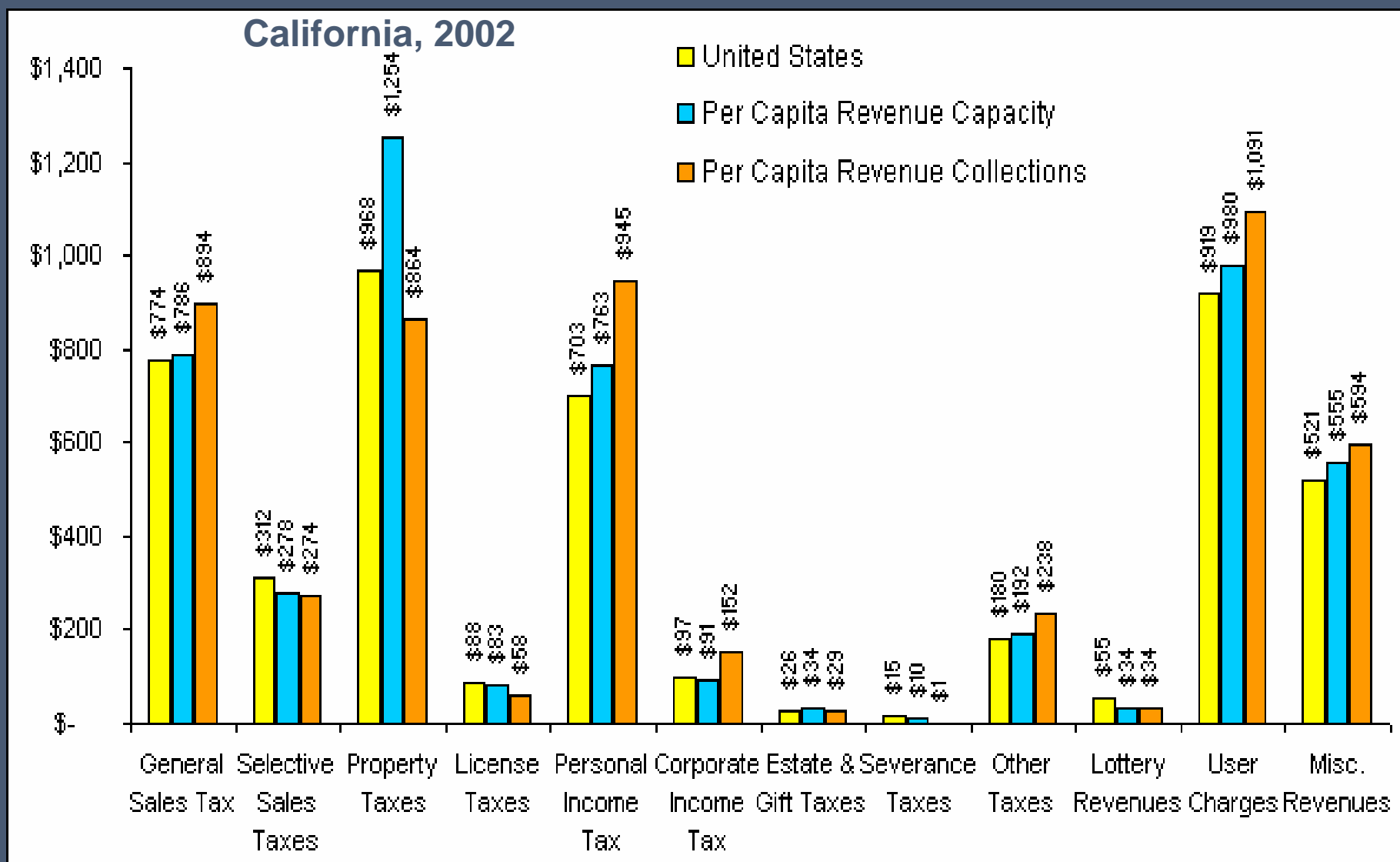
Revenue Capacity Across States, 2002



Expenditure Need Across States, 2002



Can Also Be Used to Examine Which Revenues Are Being Used/



Who Pays the Tax Burden?

- The person sending the check to the government is not necessarily the person made worse off by the tax.
- Businesses do not bear the burden of taxes, only people do. Thus, a tax on a business transaction is borne by:
 - Customers
 - Business owners
 - Workers
 - Suppliers
- Taxes are borne by those who are least able to escape them
 - If consumers, the tax is “shifted forward”
 - If others, the tax is “shifted backward”

Evaluation Framework

- **NCSL Principles**
 - Generally accepted
 - Quantitative and qualitative concepts
 - Overlap and conflict, need to trade-off
1. Reliable
 2. Neutral
 3. Complementary
 4. Balanced
 5. Fairly and Efficiently Administered
 6. Accountable
 7. Promotes Compliance
 8. Equitable
 9. Economically Competitive

Principle 1: Reliability

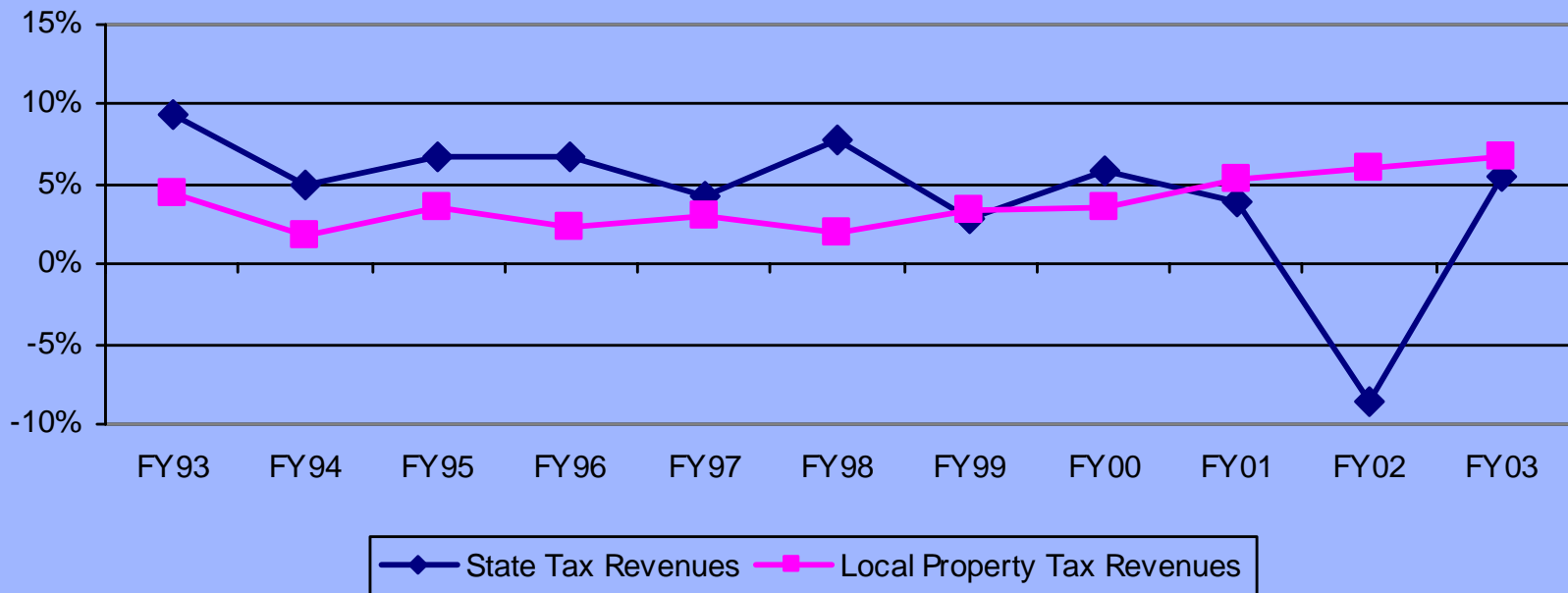
- **Stable**
 - Predictable and relatively constant
- **Certain**
 - Changes in tax structure kept to a minimum
- **Sufficient**
 - Raises adequate revenues (budgets balance each year)
 - Revenue growth keeps pace with economy and desired spending levels

Revenue Stability

- Two common measures
 - Long-term average growth
 - Year-to-year fluctuations
- Revenue volatility
 - Property taxes more stable
 - Income taxes - less stable especially if progressive
 - General sales taxes – middle level of stability
 - Excise taxes – depends on neighbors, economy

Stability - CT

Total State Taxes and Local Property Taxes
Annual Revenues Growth: FY 93-FY 03



Source of Data: State Comptroller and OPM

Principle 2: Neutral

- **Minimizes influence on economic decisions (investment or spending), little “market distortion”**
- **Minimizes earmarking (dedicating revenues to specific purposes)**

Principle 3: Complementary

- Objectives should be consistent
- Recognize limitations and responsibilities of local government
- Limit competition for tax bases

Principle 4: Balanced

- **Levy variety of taxes – across levels of government**
- **Ideally, major taxes contribute nearly equal proportion to total revenue – 3-Legged Stool**

Cross State Comparisons

State and Local Tax Collections by Source: Percentage of Total Taxes, 2002

	Property	Sales	Indiv. Income	Corporate	Other
U.S. Total	30.8	24.6	22.4	3.1	19.0
Connecticut	39.6	20.1	24.4	1.0	14.8
<i>Northeast Region</i>					
Maine	42.1	18.4	23.6	1.7	14.1
Massachusetts	36.5	15.5	33.1	3.4	11.5
New Hampshire	60.3	Na	2.0	10.5	27.2
New Jersey	46.3	17.3	19.8	3.2	13.3
New York	30.2	18.7	34.0	5.7	11.4
Rhode Island	40.4	20.2	22.7	0.8	16.0
Vermont	41.9	10.9	20.8	1.9	24.5
<i>Selected Other States</i>					
California	25.1	26.0	27.4	4.4	17.0
Colorado	29.9	29.7	25.0	1.5	13.8
Georgia	27.6	31.1	27.0	2.4	11.9
Missouri	25.7	28.1	26.0	2.0	18.2

Source of Data: Federation of Tax Administrators (based on U.S. Census, 2002)

Principle 5: Fairly Administered

- **Easy to implement**
- **Simple system**
- **Uniformly applied**

Fairly Administered

- **Corporate income tax – varies by state often complex and prone to avoidance, breaks**
- **Personal income tax – individuals within the same income bracket are treated the same**
- **Sales tax – exemptions can create confusion and tax is prone to avoidance**
- **Property tax – variation in timing of assessments affect uniformity and fairness**

Principle 6: Accountable

- **Explicit in how revenues are raised**
- **Changes well publicized**
- **Costs and benefits of tax policy examined**

Principle 7: Promotes Compliance

- **Easy to understand**
- **Minimizes compliance costs**
- **Taxpayers believe tax and treatment are fair**

Principle 8: Equitable

- **Impose similar tax burdens on people in similar circumstances**
- **Minimize regressivity**
- **Minimizes tax on individuals with low incomes**

Principle 9: Economically Competitive

- Tax burden should not be very different from other states
- Tax base should provide for services that are similar to surrounding states
- Disagreement among experts about whether “tax burden” is a concern in keeping a state economically competitive, especially in global business environment

Equity

- **Taxes should be borne by those who:**
 - Have the highest ability to pay
 - Receive the benefits of the spending generated by the tax
- **Implications:**
 - Income taxes most progressive
 - Sales taxes most regressive
 - Property taxes – depends on if taxes passed on to renters

Efficiency

- **Similar goods should face similar taxes**
 - **Consumers are responsive to price changes on a good if close substitutes are available and are available at a lower price**
 - **Therefore, tax policy should tax similar goods at similar rates and should tax firms providing the goods at the same rate**

Efficiency: Pollution and Congestion

- If production or consumption of a good or service creates pollution or congestion, then a tax can help align societal and individual costs and lead to better outcomes.
- Implications for taxes:
 - Reason to tax gasoline, cigarettes, alcohol
 - Other behavior want to discourage or feel has social costs different than private costs
- Note that if become dependent on revenues may face conflicts in public policy goal and revenue need

Special Issues Relating to State and Local Governments: Tax Exporting

- Tax exporting occurs when state and local governments impose tax burdens on non-locals.
- This can not be done directly because of the interstate commerce clause.
- It can be done indirectly by taxing goods or services used disproportionately by non-locals at a higher rate.
 - Hotel tax is a good example
- In many cases it is optimal for state and local governments to do this
 - Non-residents don't vote locally
 - But it can be overdone and backfire, decrease economic activity
 - Sometimes local residents use service – leads to inequity across classes of residents

Special Issues Relating to State and Local Government: Balanced Budget Rules

- **Almost all states and localities operate under balanced budget rules (of varying severity).**
 - **This can create problems over the business cycle, since revenues fall and required spending rises during downturns.**
 - **To deal with this, states and localities try to diversify their tax bases.**
 - **Importance of rainy day funds**

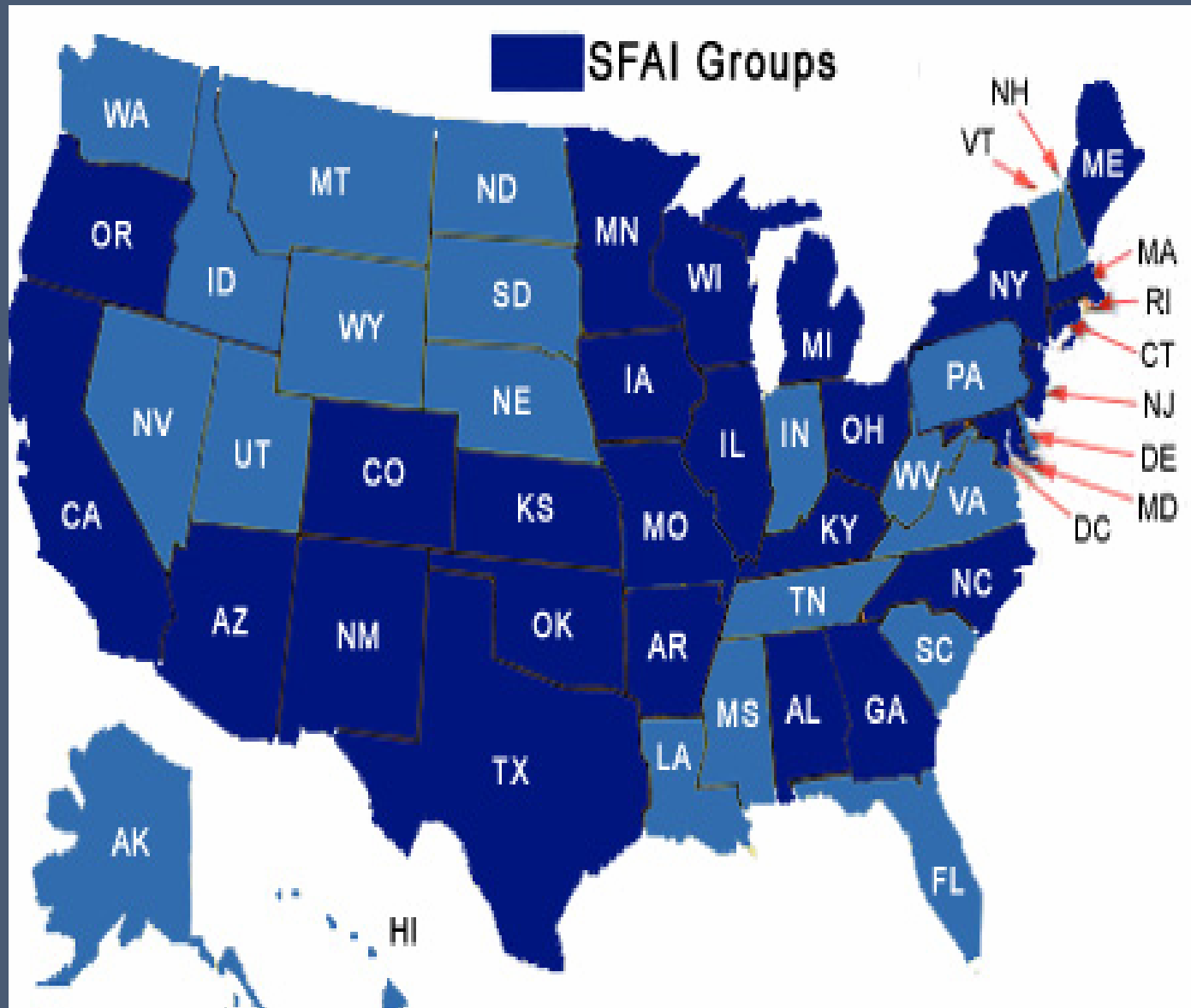
Tax Limitation Movements

- **Over half of all states have a limit on either revenue or expenditure growth at the state or local level**
 - **Beginning with Proposition 13 in CA in 1978**
 - **Limit growth to inflation or income growth**
 - **Sometimes require super-majority votes for new taxes**
 - **Or require voter approval for new taxes**
- **More recent limits follow Colorado's TABOR**
 - **Stricter limits on revenues or expenditures often for state and local governments**
 - **Voter approval required**

Success in Fighting TABOR Limits

- Colorado amended/suspended limit in 2005
- In 2006, measures proposed/pushed in a dozen states
- Three made it to ballot – all defeated
- In part based on organized opposition (CBPP, local networks) www.cbpp.org/ssl-series.htm
 - Focus on role of outsiders in bringing rules
 - Focus on costs in terms of service declines
 - Building coalitions – ideally including services and businesses
 - Key information if facing legislation
 - SFAI Network good resource for information in 29 states

SFAI Networks in 29 States



Conclusions

- Revenue system important to provide services
- Important to take into account total system facing taxpayers, how taxes interact
- Want to balance characteristics of high-quality system
- Raise money equitably but try not to hurt economic base
- Sometimes (often) politics trumps policy goals
 - Use tax that can get passed