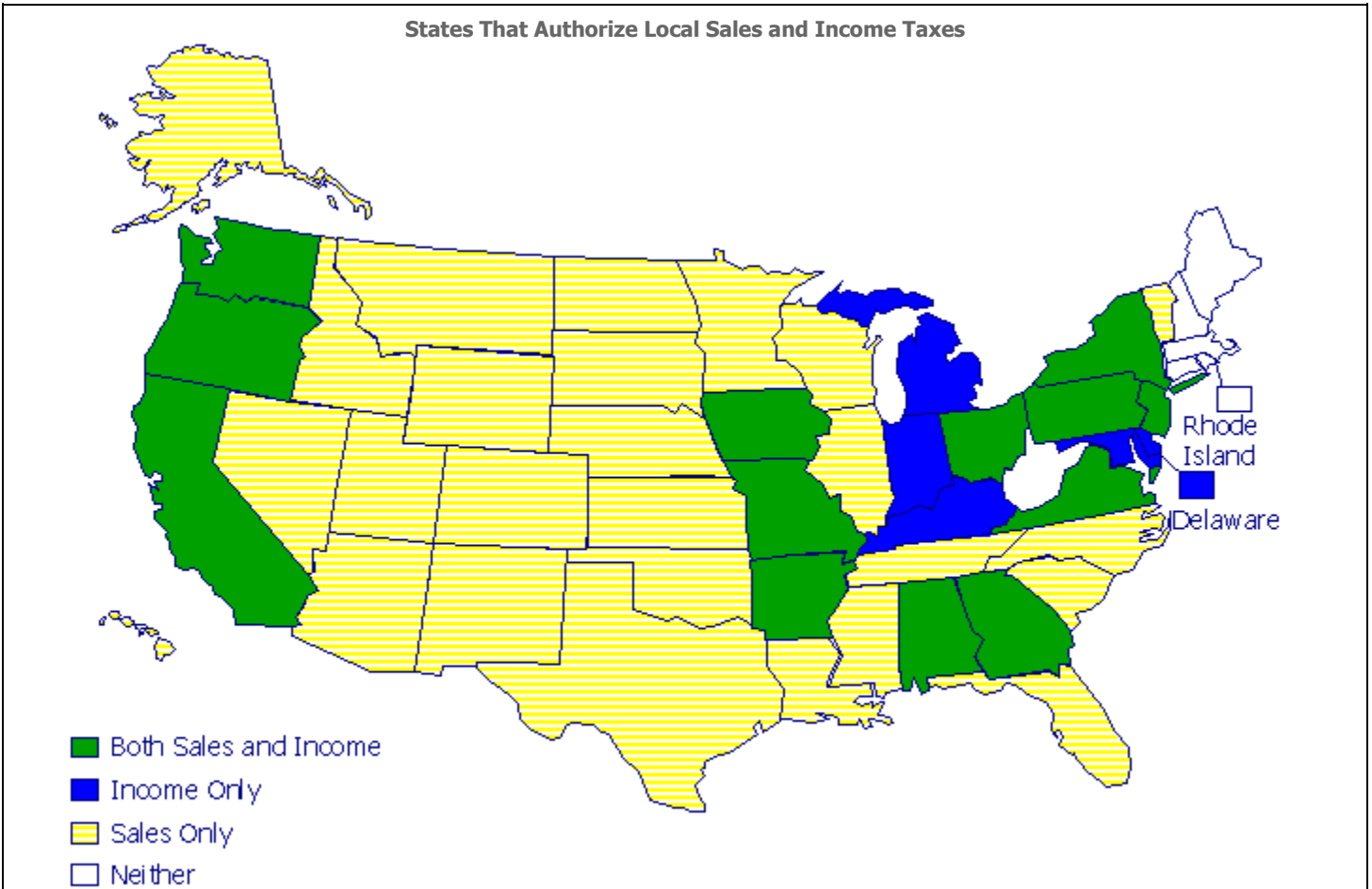


## Local Option Taxes

Local option taxes are taxes levied with state approval by municipalities, county, and special district governments including school districts.

- Forty-three states authorize local option sales and/or income taxes
- Three quarters of states (38) permit local sales taxes (12 percent of local tax revenue)
- One third of states (18) permit local income and payroll taxes (5 percent of local tax revenue)
- Other examples: tourism (lodging, car rental, etc.), tobacco and alcoholic beverage excise, real estate transfer



Source: National Conference of State Legislatures, 2006.

States that Authorize Local Sales and Income Taxes		
State	Local Sales Taxes	Local Income Taxes
Alabama	x	x*
Alaska	x	
Arizona	x*	
Arkansas	x	x*
California	x	x*
Colorado	x	
Connecticut		
Delaware		x*
Florida	x	
Georgia	x	x
Hawaii		
Idaho	x*	

Illinois	X	
Indiana		X
Iowa	X	X**
Kansas	X	
Kentucky		X*,**
Louisiana	X	
Maine		
Maryland		X
Massachusetts		
Michigan		X
Minnesota	X	
Mississippi	X*	
Missouri	X	X*
Montana	X*	
Nebraska	X	
Nevada	X	
New Hampshire		
New Jersey	X*	X*
New Mexico	X	
New York	X	X*
North Carolina	X	
North Dakota	X*	
Ohio	X*	X
Oklahoma	X	
Oregon	X	X*
Pennsylvania	X	X**
Rhode Island		
South Carolina	X	
South Dakota	X	
Tennessee	X	
Texas	X	
Utah	X	
Vermont	X	
Virginia	X	X
Washington	X	X
West Virginia		
Wisconsin	X	
Wyoming	X	
<b>Totals:</b>	<b>38</b>	<b>18</b>

\*Limits may apply. Examples: Certain cities; cities or counties of a certain size; resort towns; home rule cities. \*\*Includes school district or school board taxes.

**Sources:** Commerce Clearing House *State Tax Guide*, 2003; Minnesota House Research Department, 2005; National Conference of State Legislatures: *A Guide to Local Option Taxes*, 1997; telephone survey, 2003; *A Guide to Property Taxes: The Role of Property Taxes in State and Local Finances*, 2004; on-line research, 2006.

<p><b>Potential Advantages of Local Option Taxes</b></p> <ul style="list-style-type: none"> <li>▪ Grant revenue flexibility to local governments</li> <li>▪ Provide additional funds for programs and services without tapping state funds</li> <li>▪ Allow diversification of local revenue base</li> <li>▪ Allow tax burden shift to nonresidents</li> <li>▪ Place some taxing and spending decisions closer to residents</li> <li>▪ Maintain local autonomy</li> </ul>	<p><b>Potential Disadvantages of Local Option Taxes</b></p> <ul style="list-style-type: none"> <li>▪ Increase combined state-local tax rates</li> <li>▪ Limit state flexibility to raise tax rates in the future</li> <li>▪ Cause competition among local governments</li> <li>▪ Increase administrative and compliance costs</li> <li>▪ No guarantee that total tax burden will not increase</li> <li>▪ Difficult to remove because of revenue impact on local governments</li> </ul>
<p><b>Considerations in Evaluating a Local Option Tax</b></p> <ul style="list-style-type: none"> <li>▪ Local accountability and flexibility</li> <li>▪ Voter approval requirements</li> <li>▪ Limits on state revenue options</li> <li>▪ Design of local option tax structures</li> <li>▪ Administrative and compliance costs</li> <li>▪ Uniformity (or lack) among local taxes</li> <li>▪ Revenue balance in the state-local tax system</li> <li>▪ Fiscal disparities</li> <li>▪ Progressivity and regressivity of the state-local system</li> <li>▪ Responsiveness to economic growth</li> <li>▪ Statewide vs enumerated local option taxes</li> <li>▪ Federal deductibility</li> <li>▪ Effects on future state tax system modification</li> </ul>	

## Discussion

For definitional purposes, "local option" refers to taxes that are levied with state approval by city, county, and special district governments, including school districts.

Examples of such local taxes may include sales, income, lodging and other types of tourism taxes, real estate transfer taxes, tobacco and alcohol excise taxes and even severance taxes. The variations are numerous and wide-ranging.

Of the 50 states, 43 permit some type of local option sales or income tax. In some cases the authority granted may be limited to cities or counties of a certain size or resort cities or home rule cities.

Three quarters or 38 states permit local sales taxes, which according to the most recent Census Bureau statistics generated 12 percent of local tax revenues. Fewer states – 1/3 or 18 – allow local governments to levy income taxes or payroll taxes, which are responsible for an additional 5 percent of local tax revenue in the aggregate. (See accompanying map and table.)

The expansion of local taxing authority can have important implications for individual taxpayers, businesses and the economy, with key policy issues that legislatures may need to consider when determining whether to grant additional taxing authority to local governments.

## Advantages of Local Option Taxes

On the plus side are arguments that local governments gain flexibility with revenues when they have some control. Revenues that may become available with the addition of a local tax can help support existing or new programs and services without additional state money. There is the potential for local revenue base diversification—that is, levying taxes on portions of the tax base that may reflect a locality's economic strengths, such as

tourism. This also can allow shifting of some of the tax burden off residents and on to visitors or other non-residents. Local taxes also place some of the taxing and spending decisions closer to residents, which may be of particular interest in geographically large states with regional diversity and varying political views. Greater accountability for taxing and spending decisions may result. Local autonomy also is supported with taxing and spending authority linked to local option taxes. Local option taxes allow voters, either directly or through their representatives, to choose whether to increase taxes to pay for services that state taxpayers may be unwilling to fund. Proponents of local option sales also argue that public opinion polls show that taxpayers prefer sales taxes over property and other taxes.

### Disadvantages of Local Option Taxes

On the other hand, there are some significant disadvantages to the use of local option taxes. Local option taxes will increase combined state-local tax rates. Local taxes reduce state control of these tax sources and affect the extent to which state governments can tap these sources for their own purposes. And diversification alters the tax burden on residents and may lead to inter-local competition for revenues. If the local option tax is a sales tax, which opponents believe is a regressive form of taxation, the poor are likely to carry a disproportionate share of the sales tax burden. Local option sales taxes also may create disparities among localities, particularly in rural states where the retail base is not evenly distributed., possibly limiting a state's flexibility to raise tax rates in the future. It is possible that local option tax structures will increase administrative and compliance costs for both taxpayers and government, especially local governments, and create confusion if separate tax bases, exemptions and collection activities are authorized. This situation may affect a state's economic competitiveness and business climate. Finally, there is no guarantee that the total tax burden will not increase. Once local option tax provisions are in place, removing or modifying them is difficult because of the revenue impact on local governments. Shifting the revenue burden from property to sales or income taxes also may worsen revenue fluctuations caused by economic cycles and worsen governmental fiscal problems.

### Policy Considerations

Policymakers considering the pros and cons of local option taxes may wish to keep in mind a variety of issues.

### Local Accountability and Flexibility

These issues can include the importance of local accountability and flexibility. States differ on whether all local governments or only those that meet certain criteria may levy local option taxes. In some states, only the largest cities or counties may levy taxes, while other states grant statewide authority. States that grant authority broadly may help minimize the tendency for tax rates to be higher in larger cities.

### Voter Approval Requirements

States also vary considerably on voter approval requirements for local taxes. It is not uncommon for a state to require voter approval for some local taxes but not others. Voter approval requirements make it more difficult for local governments to levy or increase a tax and may delay imposition of a tax until the next election. Also, if voter approval is required for some local levies but not others, the local governing body may choose the path of least resistance and impose taxes that do not require voter approval. On the other hand, voter approval requirements force local governing bodies to carefully justify tax increases. Such requirements tend to minimize the number of times that local governments seek rate increases, creating a more stable tax climate.

### Limits on State Revenue Options

It is possible that state decisions about the type of local option taxes authorized can alter the progressivity or regressivity of the entire state-local tax system. The federal government makes extensive use of the income tax but levies few consumption taxes. By default, state and local governments must rely primarily upon property and consumption-based levies that are viewed by many as regressive. Policymakers may want to consider whether a proposed local option tax alternative will increase or decrease the regressivity of their state-local system.

### Administrative and Compliance Costs

Administrative and compliance costs may be an issue. Businesses that must file multiple tax returns will incur increased compliance costs, as will governments.

### Uniformity

Assuming local option taxes are permitted by the legislature, uniformity among these taxes also may be a consideration. Uniformity can reduce the potential for competition among localities that want to attract new or expanding businesses, and a single set of tax rules can reduce the costs for all parties. Local option tax systems that are added to existing uniform, statewide tax bases also can help minimize compliance costs for taxpayers and preserve the state government's ability to maintain control over the state's economic competitiveness and business climate as a whole.

## Balance

One principle of a high quality revenue system is balance. Balance means that states have a roughly equal mix of income, consumption and property taxes. Balance allows states to keep rates as low as possible in any one tax, minimizing the potential that the tax system will distort economic behavior. Balance also improves the stability of state-local revenue systems by distributing the tax burden to various types of economic activity. States will want to consider how granting local option taxation will affect the balance of the state-local tax system.

## Fiscal Disparities

There will be disparities in the tax base available to finance services any time local rather than state taxes are used. The primary reason that states have expanded their role in funding education is to alleviate these disparities. Although property tax disparities receive a good deal of attention because of their school financing role, other tax sources actually may create larger fiscal disparities. When evaluating the use of local option taxes, state policymakers will want to consider whether a local option tax alternative will improve or exacerbate the fiscal disparities among local governments in the state.

## Responsiveness to Economic Growth

Economists use the term elasticity to describe the responsiveness of a tax—or a tax system—to personal income growth. Elastic sources increase more quickly than personal income, while inelastic sources increase more slowly than personal income. Income taxes are typically the most elastic state-local revenue source, while excise taxes typically are the most inelastic. State policymakers will want to consider whether the local option tax source will produce the long-term revenue growth necessary to finance the programs being funded by local governments. Authorizing an inelastic revenue source to pay for high-growth programs like jails or health care may lead to budget problems in the future.

## Statewide vs Enumerated Local Option Taxes

As I mentioned earlier, states differ on whether all local governments or only those that meet certain criteria may levy local option taxes. In some states, only the largest cities or counties may levy taxes, while other states grant statewide authority. States that grant authority broadly may help minimize the tendency for tax rates to be higher in larger cities.

## Inter-local Competition

Just as states compete with one another on the basis of tax policy, local option taxes may lead to competition among local governments. This competition may create an adversarial relationship among localities, as they try to use a competitive tax policy to lure businesses and residents. This has been the case in Colorado. Such competition does not improve the state's overall economic performance and possibly diverts resources from more productive uses.

## Federal Deductibility

State and local income and property taxes are deductible from federal adjusted gross income. Under current federal law, state sales and other consumption taxes also are, although a choice must be made to do one or the other. Federal deductibility can reduce the tax price of taxes, particularly for those taxpayers who face high federal income tax rates. Shifting from deductible to nondeductible local taxes may increase the amount of federal taxes paid by state residents.

## Future Tax System Modification

Finally, and perhaps most important, state policymakers may wish to consider at length how granting local taxing authority could affect future state tax system modifications.