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State-Local Taxation
An Overview

By C. LOWELL HARRISS

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For state-local government as a whole the actions of recent years in adding new taxes and in raising the rates of old ones, plus the increase in federal aid, assure revenue increases which can pay for the existing quality of state-local services supplied to a rising population and also permit continuing improvement, says the author. C. Lowell Harriss is professor of economics at Columbia University in New York City.

BY WHAT CRITERIA does one judge a tax system? Three may serve: revenue adequacy, equity in distribution of the costs of government, and "efficiency" in the sense of conformity with (or least obstruction to) economic and social progress. Each of these, however, has many aspects. Just think of the meanings of "equity" as applied to taxation. Or the host of elements which combine to make up "progress" and the countless ways in which taxes influence producers and consumers (beyond the obvious extraction of dollars).

Additional complications arise from the fact that each of 50 states has devised its own tax system, and Congress has developed a 51st for the District of Columbia. Within the states, around 70,000 local governments impose taxes in variety beyond any possibility of examination here.

So I shall be selective. Doing so enables me to touch a bit on each of the criteria—revenue adequacy, equity and efficiency.

"Enough" Revenue? Perhaps

You might almost jump in startled disbelief if I were to say, "State-local tax systems will yield adequate revenue." Such would be too sweeping. But the facts are more than impressive.

State-local tax systems now yield revenue on a scale which only a few years ago would have seemed beyond belief—five times as much as 20 years ago, with annual rates of expansion of about 9 per cent. New accounts highlight "gaps" and "shortfalls" and "unmet needs." But what is news can give an erroneous impression of the more typical cases. A more comprehensive overview is now possible.

Dr. Elsie Watters of the Tax Foundation will soon present new projections of state-local expenditures and revenues. She has made her preliminary figures available, subject to revision.[1] In summary, they leave no doubt that *existing* state-local tax systems (plus federal grants *already* on the books and various charges and other nontax

*Views expressed are the author's and not necessarily those of any organization with which he is associated. Assistance from the John C. Lincoln Institute of the University of Hartford is acknowledged with thanks. These remarks represent a modification of a paper Professor Harriss gave at the last Tax Executives Institute Conference in San Francisco.

[1] Dr. Watters, Director of State-Local Research of the Tax Foundation, Inc., presented preliminary projections at the September 1971, conference of the National Tax Association. More recent revisions will be published in 1972.

sources) will finance expenditure growth at a rapid rate. On assumptions which seem to me reasonable, revenues will "rise enough to meet foreseeable "needs" —by a definition of the term which is more generous than strict. This concept of need allows an "improvement" factor equal to that of the 1960s.

State-local tax systems now have more automatic upward elasticity than is often recognized. If property value increases were reflected more promptly in assessments, the revenue responses would be even prompter and larger. In three years through 1970 *per capita* state-local taxes rose by nearly $100 to $427. Making rough allowance for tax changes voted in 1971, I see Dr. Watters' 1975 projection as over $600 *per person* ($3,000 for a family of 5) in 1975.

The state-local tax systems now on the statute books will finance a rising level of performance of functions, including improvement of quality (after allowing for inflation). Adequate? A few comments later.

These conclusions apply to the country as a whole. Exceptions will exist, and some will stand out. Some large cities, for one reason or another, will depart from the general average. The amounts can present difficult strains in individual cases.

But for state-local government as a whole the actions of recent years in adding new taxes, and in raising the rates of old ones, plus the increase in federal aids (over 10 per cent a year projected to 1975 without new programs), assure revenue increases which can pay for the existing quality of state-local services supplied to a rising population and also permit continuing improvement.

These projections, let me emphasize, build *cumulatively* upon more than two decades of high rates of expansion of state-local taxes and spending. Year after year annual growth rates—*without* federal grants —have been nearly 10 per cent. This rate is much above the rate of rise in personal income or in federal spending (or revenues) or in corporate earnings or in gross private domestic investment.

State-local government (excluding federal aid) has been *the* growth sector of economy. Taking into account the $25 billion increase (1972 fiscal year over 1950) in federal grants, one finds even greater evidence of the expansion of state-local spending.

In other words, and in addition to high federal taxes which finance growing grants in aid, the American people have already subjected themselves to state-local taxes at levels far higher than ever before. Some states and communities, of course, impose much heavier taxes than others. By the standards of, say, the top quarter in providing services and taxing to pay for them, some are much below.

Unquestionably, many advocates of greater spending will find the growth rates of the projections "inadequate." Present taxes, and even higher ones, can never meet "desires"—and, as seen by some persons, "needs"—for more government spending.

Property Taxation: More Progress, Less Poverty, Greater Equity

The largest revenue producer deserves more citizen and business attention—and in much of the country more intensive use. It has faults galore. As it exists in practice one place or another it can be justly criticized by every criterion relevant for judging a tax. Yet property taxation can be made into one which by every criterion is a good tax—and by some seems to me to be the best of all taxes for a large fraction of local expenditures.

Property taxation will be with us, as a major element of the economy, for as long as we can see. But gross inequities exist because of poor assessment. High rates on buildings impair economic progress. Low rates on land discourage best use. Increases in value created by society which seem to me the most equitable basis for financing (local) government are taxed only slightly. The opportunities, and therefore the challenges, for improvement are huge. They ought to get the best efforts of which we are able.

The general outlines of reform seem to me clear. Much agreement will be found, some disagreement—and a lot of opposition. As I have studied property taxation over the years, here and abroad, I have become increasingly convinced that feasible improvements offer tremendous hope for bettering our communities, our businesses, our homes, our whole economy—while distributing the costs of government more equitably.

Better Administration. — Some of what needs to be done should be obvious—improve administration. One can pick almost any adjective of opprobium, and it would properly apply to property tax administration in more than one community. The defects *can* be reduced. They should be. The methods have been formulated. Many have been tried, and tried with considerable success, in more than one place.

One would hope that civic organizations, business and professional associations, and other groups seeking to advance the public interest would give active support to property tax reform. The recommendations made years ago by the Advisory Commission on Intergovernmental Relations provide a solid basis. The Federation of Tax Administrators and the International Association of Assessing Officers among professional organizations have continuing interest and exert leadership for improving administration. Within some states and localities there has been constructive effort, as well as obscurantist opposition. State governments have a potential role of major importance. But the lags are distressingly long and numerous.

Hardship Relief and Exemption.—Another area of property tax improvement is, in the words of the Advisory Commission on Intergovernmental Relations, removal of the "equity stingers." Relief can be granted to older persons and families of low income without undue cost. The issue of the erosion of the property tax base through exemptions calls for effort in much of the country.

Rational Recognition of Economic Reality: Site Values as the Base for More Revenue.—A more fundamental reform rests upon a basic economic principle. In an inherent economic sense "the" property tax is two basically different levies. One rests upon land as the product of nature and society. The second is the tax on buildings, machinery and other man-made property.

Reform of the property tax offers an opportunity for a change which *can* be achieved and which will alter the incentive system so that men will then modify their private behavior in ways more conducive to community well-being.[2]

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[2] This section draws heavily upon material I have presented on other occasions. Fuller analyses of some points appear in C. Lowell Harriss and W. J. Shultz, *American Public Finance,* 8th ed. (1965); *The American Economy,* 6th ed. (1968). In *Property Tax Reform: More Progress, Less Poverty,* Paul L. Morrison lecture at De Pauw University, I deal more fully with the basic rationale. "Property Taxation: Modernizing the Basic Structure," *The*

The basic idea is old—but largely untried: Reduce tax rates on buildings and machinery, substantially, and boost the rates on land values. The use of land values to finance local government offers attractive opportunities. High and rising land prices could provide more funds than they yet do for much needed services of local government.

In many localities the property tax now exceeds $220 a year per capita—over $1,100 for a family of five. At such levels it exerts powerful effects, not merely the taking of money but also the influencing of investment and land use. Nonrevenue results are substantial.

The tax on buildings (and on machinery, inventory, and other tangible personal property) can have the most undesirable nonrevenue effects. The quality and quantity of improvements, including housing, suffer. The tax on land, however, can be one of the best to get funds for local government. In fact, the tax on land value can be the most nearly painless way to raise large revenues—and to raise them equitably—while exerting desirable nonrevenue results.

Urbanization—Costs of Space and Land Prices.—The quality of life for the tens of millions who live in cities suffers because funds are not adequate for the facilities which governments are expected to provide. Yet, people pay "heavily" for living and working space in the city. Their demand for room sends land prices up and up. And most of the increasing amounts which urban residents pay for the use of city land go primarily to private owners. The issue is not whether the user must pay but how much will go to government, how much to the owner of land at purchase or by annual rental.

The congestion in cities which multiplies the need for governmental services also creates a potential source of funds for meeting some of the costs (1) without making the user of land as such the worse off and (2) without endangering the supply of land. Moreover, the tax which brings about this result can also exert pressure to put land to better use.

Land—Location—as a Product of Nature and of Society.—Urban land as a productive resource resembles labor and capital in some respects but differs crucially in others. The similarities include the fact that parcels of land, especially the desirability of location, vary greatly, as do human skills and machines. An outstanding difference is the way they come into existence. Labor and capital are man-made. The quantity and quality of training, the vigor of human endeavor, the amount of machinery and structures—all these depend in part upon what individuals expect to get in compensation and the payments they actually do receive. To get such productive capacity, society must pay. Moreover, attempts of society to take back through taxes what customers have paid for the services of capital and labor will affect the future supply.

Not so, land. Nature created it in the physical sense—and society has created much of the demand which makes some location highly desirable. The amount of land in existence will depend scarcely at all upon the amount paid to use it. The payment, however, does make a difference in what becomes available for active use, and

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(*Footnote 2 continued.*)
Bond Buyer, June 1, 1971, summarizes the major points. Equity aspects are the subject of "Equity of Heavier Reliance on Land Taxation (Location Value) and Less on Improvements," in *Tax Policy,* Tax Institute of America, Sept.-Dec. 1970. The Tax Foundation, Inc., has scheduled publication of a revision of my Government Finance Brief, *Property Taxation: Economic Aspects,* for 1972.

the particular use to be made of a parcel, its allocation among alternative uses.

Because parcels of land, especially in their characteristics as space and location, do differ immensely, something to help allocate use efficiently is of utmost importance. Payments for use of land do perform a function of outstanding significance—allocation—but *not,* as for man-made productive capacity, also the function of inducing the creation of the productive resource.

Except, and this exception is important: costs borne by private developers, and even more so the costs incurred by the community, do affect the desirability of locations. Around large American cities from $15,000 to $20,000 of government spending on streets, schools, water and sewage, and other facilities is often needed for each new dwelling. As such facilities are built, as population grows and incomes rise, land prices go up. The National (Douglas) Commission on Urban Problems estimated that in the 10 years to 1966 (and despite rising tax and interest rates), land prices rose by over $5,000 per family. Even a modest fraction of the $250,000 million if used for financing local government would have permitted a welcome reduction of burden on buildings.

Criticisms of property taxation as seriously regressive fail to recognize that the tax on land is "capitalized"; prior owners have, in effect, paid the tax in perpetuity; present owners or users do not bear the burden whatever they may believe. Moreover, a part of the tax on buildings and machinery is a general tax on capital. The owners of capital cannot, in fact, shift all of this tax to users (consumers or tenants) or to owners of land. The results are more complex than can be examined here. But the analysis casts much doubt upon the regressivity conclusion. Certainly, owners of large amounts of property will often bear large amounts of the tax. And low income and wealth groups owning little or no property will bear little or none of the property tax as it falls upon suppliers of capital.

Land cannot move. Its quantity—space in its basic nature—is fixed. Tax it heavily, and it will not move to some other place, or decide to take a vacation, or leave the inventory of productive resources by going out of existence. Tax land lightly, and the favorable tax situation will not create more space on the surface of the earth. Rarely will the amount of space or surface in an area be subject to more than a little change by actions under the control of man. The value of location does depend in part upon what is done, especially by society, to make the area attractive. Prices of land, often "high," result to a considerable extent from investments by the general body of taxpayers. A heavy tax on land will not reduce the supply of space. And it can recapture, to pay some of the costs of local government, much of the annual rental value or worth of what the public itself has created.

Private Ownership of Land.—Does the ethos which ties equity (economic justice) to rewards based on accomplishment lead to justification for large rewards because of ownership of land? Differences, perhaps big ones, in payments for human services or for the use of capital can rest on what the recipient has done, his accomplishments as valued by consumers in the market. But the owner of urban, and suburban, land has difficulty showing any comparable justification.

The "moral" justification for reward related to creativity gets a bit thin and tenuous when related to many of the increments in land prices. The owner's contribution to production may have been nil or slightly positive in getting land into better use from time to time. But he may have kept it in a use much below the true potential worth to the community. Compared with labor and capital, land offers much greater possibilities of enhancement of private wealth without regard to the productive contribution of the person benefiting. The owner, however, does have incentive to allocate and to direct use into better rather than poorer alternatives. The scarcer the land and the greater the price it can command, then the more important for the community that it be used well. Private ownership presumably tends to bring about this result.

Urban sprawl is familiar. A drive in or around a large, or not so large, city leaves no doubt that failures to make best use of land do occur. They are most likely to result when the owner is free from great pressure to search out the best opportunity and then to exploit it. If he is ignorant of the possibilities, he will not get land into best use. Or he may be well enough supplied with income to be able to indulge his preferences for some suboptimal use. Out-of-pocket costs (after taking account of income tax deductibility) may be relatively small. Perhaps he may delay change in land use because sale of his land would bring a heavy tax on capital gain.

Property Tax Effects on Structures.—The supply of buildings presents a striking contrast to land. Heavy taxes on buildings produce several nonrevenue results. These taxes help to account for some of the deplorable features of our cities. There is merit in reducing the tax rate on structures.

The property tax on buildings hits well-constructed, high-quality, structures far more heavily per unit of floor space or cubic contents than it does slums and "junk." The element of property taxation which falls on buildings creates an incentive against upgrading of quality, especially in those parts of older cities with most urgent needs but also with high tax rates. Such unintended and undesirable discouraging of private effort to raise quality does not come from the tax on land.

When his tax bill goes up because an owner has constructed a better building, he does not get correspondingly more or better government services. But his investment will usually have produced advantages for others around. As compared with the old, deteriorated, property on which tax was low, the new, high-quality building will bring the general public positive "neighborhood benefits."

Would not wise public policy encourage better structures? Without deliberate design, the present tax favors buildings which produce bad neighborhood effects. The owner of dilapidated structures—residential, commercial, industrial—will be freer from economic pressure to replace with something better if his tax goes down because the building gets worse. Any individual or business wishing to shift to use of a higher quality structure must also pay more toward the costs of government—$1 more of taxes for each $3 (or even $2) of annual payment for the better facilities themselves.

Cities which urgently need to replace obsolete buildings must now rely heavily on a tax which creates a bias against replacement.

Taxes and Maintenance.—The quality of space within buildings available for work and living will depend greatly upon the *maintenance* of the stock of older buildings. Undermaintenance forms one way by which an owner can reduce his net investment in a building. His actions in letting a building run down will affect others, the larger neighborhood. Deterioration of a minority of buildings can hurt a considerable area. Good maintenance can be combined with spending for improvements which have "spillover" benefits for the whole neighborhood.

Though often overshadowed by income tax and other considerations, property taxation has some influence on maintenance, adverse influence. The tax reduces the net return from the structures and thus the attractiveness of putting more dollars into such properties. Dollars paid to the local treasury are not available to finance maintenance. And with or without good reason, the owner may fear that a "repair and maintenance" job having visible results will bring an assessment increase.

Effect on Price—Building and Land.—The property tax on buildings adds to the cost of supplying them and to the price which must be charged.[3] The tax on buildings, but not the tax on land, deprives the consumer of more real benefit than the dollars paid to government. For example, within considerable limits, the cost per cubic foot of construction declines as the size of the house, apartment, office, or other unit increases. The tax on structures, however, creates pressure for building smaller units, with less of what we really want in living room and amenities per unit of labor materials used in construction. By indirectly altering the type of construction, the tax on buildings thus deprives the occupant of potential benefits for which government treasuries get no dollars.

The tax on land, however, makes for a lower price. If tax is increased, the amount remaining for the owner drops. The price a buyer will pay goes down. Government taxes more. The user pays no less for each year's use, but government through taxes preempts more.

In this way property taxes on land are "capitalized." They reduce the price which a buyer will pay. Thereafter, the user (buyer) of the land turns over, in effect, a part of the yield or produce to government. But the person who has purchased after the tax became effective does not suffer from it. The owner of land at the time "paid" the tax increase in perpetuity. In practice, what he fails to get may be only a portion of what would be a rise due to social change. Land prices will vary inversely with taxes, other things being the same. But higher land taxes may provide better services of local government and permit lower taxes on buildings and by encouraging construction raise demand for land. The actual decline in land prices may over a period of time be less than originally expected—or in some cases not actually develop at all.

Other Undesirable Effects of High Taxes on Improvements.—High tax rates on buildings (and little reliance on land value) will reinforce incentives for creating "islands" of relatively low tax rates. A few localities in the metropolitan area will have tax resources which are above average in relation to service obligations. With lower tax rates they can have above average quality of services, attracting still more investment.

Some communities use zoning power to exclude types of property associated with high governmental expense —the high-density housing which requires heavy school costs. Other parts of the metropolitan area, how-

[3] The extent to which the tax falls on consumption rather than on suppliers of capital cannot be determined clearly. In cities with property tax rates on true value which are above the general average new capital will not enter unless investors believe that users of the new structures will pay.

ever, must pay higher taxes; elements of a vicious circle gain strength.

"Lower" taxes on buildings in the fringes encourage dispersal and the development "far out" of activities (including housing) which "ought not" to be so distant. Each increase in tax rate near the center will reduce the value of the property and the tax base. Many buildings in the older section will have deteriorated but yet have some "useful" life and a potential of prolonged decline before replacement. Owners of land with obsolete buildings delay replacement, in part because the speculative holdings of the land can involve little out-of-pocket tax costs. The tax base tends to go down, aggravating the need for higher tax rates. Businesses become vulnerable to competition from outlying neighborhoods.

People who wish to escape the urban center must leapfrog over the "islands." Such land use imposes higher costs than if population were spread more in accord with factors free from the influence of tax on buildings. The disadvantages take the form of (1) costs in time and money of traveling greater distances from home to work; (2) higher expense of supplying water, sewer, and utility services over the far larger area; and (3) reduction in economic and social benefits with concentration of population facilities.

Basic Reform.—A change in the economic framework would permit raising the same amount of revenue but with significantly different, and better, nonrevenue results.

Progress will come from redesigning property taxation, not to reduce total revenue yield (for needs of local treasuries seem too great). The change would recognize and build upon the essential difference between land and buildings (as well as tangible personal property). Both the legal (constitutional) and the administrative conditions would differ widely from one state to another—and among localities within each state. In effect, the tax rate on buildings and other improvements would go down and the rate on land would go up. Perhaps a 1 to 3 rate relation would be a reasonable goal, but even bigger differentials would seem to me desirable if quality of administration would permit. Substantial cuts in burdens on structures could be financed by higher taxes on land—with large benefits to the community.

Business Taxes

State-local use of "business" taxes is overshadowed by federal income and payroll taxation. The temptations to tax "business" are understandably attractive. Where revenue pressures are great, lawmakers may be inclined to tax people indirectly through business, rather than directly through consumption and income taxes.

People, Not Things, Bear the Burden of Taxation.—Taxes are paid by people. One may speak of taxes falling on business, corporations, cigarettes, property, inheritances, income, or some other tax base. Yet it is not things, but people, who are deprived. Failure to recognize this fundamental lies at the base of much avoidable error in making tax policy.

Hidden Versus Evident Burdens.—In some cases it is much easier than in others to judge which individuals will be affected by a tax—and by how much.[4] In choosing to use hidden taxes, those which "conceal" the costs of government from the persons who pay, society sacrifices one instrument for helping to make better, rather than poorer, decisions on government

[4] Debates over tax shifting continue with enough vigor to demonstrate that doubt about the eventual resting place of some business taxes remains.

spending. True, something can be said in favor of arrangements which free us from worry about taxes. Yet is there not more to be said for the principle of selecting taxes which are sufficiently evident to the taxpayer to enable, or force, him to relate them to the expenditures of government? Another, and perhaps more serious, indictment of indirect taxation is that one form consists of heavy burdens on businesses whose operations suffer as a result.

Justice in the Distribution of Tax Burdens.—Taxes, whether borne directly or indirectly, will be not only *heavy* but also *unequal.* Some people must pay much more than others. Being heavy, unequal, and the result of the use of government's power of coercion, taxes should be generally *fair, just, equitable.* Notions of what is fair in taxation differ considerably and always lack precision.

Two conclusions, however, seem clear: (1) Taxes on business income are *inequitable* by *any* reasonable standard, but on this score they compare moderately well with taxes on consumption and property (wealth). (2) One basis for condemning American taxes on business as they actually exist is that these levies run counter to reasonable standards of fairness. The public, however, seems sufficiently misguided to support the continuation of these taxes whose real burdens fall in ways which hardly conform to ideas of justice.

Role of Business.—Businesses are the organizations upon which Americans rely for most of what is produced. Although valuable results come from the efforts of teachers, judges, military personnel, and other employees of government—as well as from the efforts of those who work for private universities, hospitals, and other organizations not seeking profit—most real income consists of what people accomplish through business firms. Employment expansion depends overwhelmingly on business.

Business is the public's major agency for organizing labor and capital to produce—and to produce more, rather than less, efficiently. Businesses are *groups of people* seeking to benefit themselves by serving others. It is this service, whether in producing and distributing *things* or in rendering *services directly,* which the public wants. The process of meeting the desires of consumers can be more or less *efficient* in terms of inputs per unit of output. A market economy relies primarily upon *competition* in markets to induce efficiency—and to stimulate growth. For it is in business organizations that we find not only the source of more of the old, but also most of the venturesomeness which leads to the innovations that contribute much to rising living standards.

The public interest calls for each business: (1) To turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market, or through government agencies. Part of this task of business is to anticipate, identifying wants which can be satisfied by new types of goods and services. (2) To produce by methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

The total accomplishment of people working as business organizations will depend upon many things: the training, inherent ability, and acquired skill of workers; their willingness to exert effort; the amount of capital—in the physical sense of buildings, equipment, and inventory, and also in the financial sense of money, without which transactions as we know them would rarely be possible; the degree of competition; present and expected demand; the state of technology and speed of scientific advance; the competence of management; and other things. Among the "other things" are some for which government is responsible—the system of law and order is one, and the tax structure another.

Taxes are *obstacles* in the sense that they take from the taxpayer without directly giving him an equivalent. Do taxes on business firms help the community to get the output most desired? Such taxes do not improve the process by which consumers indicate the relative importance of their many desires. Nor do taxes on business income help managers learn about the relative scarcities and productivities of inputs. But taxes *do* affect the alternatives which a business manager must consider, the incentives open to him when acting for the company. One incentive is to reduce taxes. In adopting methods which cut the tax bill, however, a business does not economize on the "input" of government or reduce in any perceptible way government's use of resources. Nor in selecting a tax-saving alternative does the firm increase its operating efficiency in the sense of using fewer real inputs per unit of output.

A business, in fact, may wisely adopt methods which are "second-best" as regards the use of resources. The tax factor makes some methods financially the best when in a more real sense they are inferior. Taxes thus give rise to an element of conflict between private and public interest. They induce the manager to redirect the firm's activities, away from what is fundamentally most efficient. Taxes lead to results which are less than optimal when judged on the basis of economic productivity and the allocation of resources.

Productive capacity is not allocated to the uses, and in the proportions, which are fundamentally best. Too much investment goes into forms with less burdensome tax consequences; too little then goes where taxes will be high. The economy loses some real income. The loss is a burden—but one which is largely concealed, which cannot be measured. As taxes on business operations have gone up, the effects of distortions have certainly increased.

Looking ahead, I am convinced that our economy "needs"—expects—more capital than is likely to be available. Federal tax policy bears upon this problem more than state-local taxation. Nevertheless, the state (or locality) which wants to benefit itself (its people) most should refrain from business taxation to the extent practically possible. In the competition for capital, taxes do make a difference, albeit one which can be overshadowed by other forces.

A business must have equity capital, and supplying it costs something. The stockholder sacrifices the opportunity to use his wealth in some other way—lending or buying power. Such sacrifice is an economic cost. Although income tax law and traditional accounting do not recognize this cost as a deductible expense of doing business, consumers will not get equity capital to work *for* them—and employees will not get equity capital to work *with*—unless the people who can provide ownership capital expect to receive total net benefits which will equal those obtainable elsewhere.

In other words, suppliers of capital, whether in debt or equity (ownership) form, expect to be rewarded. What counts are the rewards *after tax*. A "normal" after-tax return on equity capital is an *essential economic cost*. The net after-tax yield which a supplier of equity capital will insist upon, in expectation, will be as high a yield (conceived broadly as a total net benefit, including growth in value perhaps as a share in economic growth) as he could obtain from any alternative use of his funds.

Expansion calls for new capital, and in the modern world mere survival often requires growth. To get new capital, the business must offer attractions which are equal to those otherwise available to the suppliers of funds. Where can the company, in turn, get funds to compensate the persons supplying capital? It must look to customers for dollars. The lower its taxes, the better its competitive position in offering adequate after-tax yields and in attracting customers.

Space limits prevent more discussion of the many aspects of state-local taxation of business. Two topics which would warrant considerable discussion are (1) taxation of interstate business and (2) various tax incentives. And each industry group will have its own state-local, as well as federal, tax concerns.

Personal Income Taxes

State—and local—use of personal income taxes has risen markedly. With the recent entry of Illinois, Ohio, Pennsylvania and other "holdouts," and with rate increases in state after state, total yields will go up even more than in the past (relative to national income). An element of upward revenue elasticity will now play a greater role in financing expenditure increases without going to legislatures for action needed to boost taxpayer obligations. Of course, the elasticity differs considerably from one state to another and does not approximate that of the federal tax.

Among states the weight of the tax (relative to personal income or when compared with federal adjusted gross income) varies widely. At the high end are, among others, Alaska, Delaware, Hawaii, New York, Oregon and Wisconsin. To identify those which are low might find disbelief on the part of readers living in such states. Clearly, however, several states using personal income taxes do so with moderation compared with others.

The tendency to pattern state taxes on federal—"conforming"—has simplified compliance for taxpayers and administration for governments. Some states, however, have sought to utilize a broader base, much closer to AGI as reported for federal tax purposes. A major objective is greater revenue per percentage point of rate imposed.

Space limits preclude further discussion of the present and possible future use of personal income taxation at the state level—and the use of earnings or personal income taxes at the local level.

The heavy reliance of the federal government on income taxation does, it seems to me, lend force to the arguments that this base is not so overwhelmingly the best for state-local use as academic writings tend to assume. The issues call for discussion which is not possible here—except to say that in fact defects of income taxation as it exists in practice destroy some of the theoretical luster of more intensive use.

Consumption Taxes

States have come to rely very heavily upon consumption taxes.[5] More and more local governments also tax retail sales and several specific products and services.

Much criticism of general sales and other consumption taxes rests upon their regressivity. The more valid basis for condemnation seems to me to be the burdening of the low-

[5] Inheritance, estate and gift taxes might well receive more attention than has recently been the case. When Congress gets to reexamination of federal taxation of transfers at death, states will probably wish to revise their death taxes.

est income groups. Is this not, really, the chief reason why men of goodwill oppose regressivity? I believe that it is. Therefore, I welcome the moves of 8 states to eliminate the burdens of retail sales taxes by tax credits for the lowest income groups. Above what is thus in effect a personal or low-income exemption, the tax as it applies will be, year in and year out, roughly proportional with consumption and almost with income through a range of income which includes most Americans. Consumption taxes do not burden saving, but they do reach spending out of income which escapes (full) income taxation as well as spending out of capital. The exemption of new saving, i. e., income which is not used for consumption, gives some, albeit small, encouragement to capital formation. Looking to the future needs of our economy for capital, I see reason to applaud such an offset to the general anti-capital bias of our tax system.

Another point is to note the extension of coverage from durable goods to a wider range of services. This trend has much in equity and economic efficiency to commend it.

Finally, but less welcome, too many of the "retail" sales taxes still apply, too broadly, to producer goods. As the tax rates move upward, so do the economic disadvantages of what is in effect a double tax. The tax applies to producer goods and then to the value of what they produce.

Growth of Spending

State-local taxation will depend so heavily on the growth of spending that some explicit discussion belongs here.

Wants Exceed Economic Capacities.—*Scarcity,* this is what economics is about. Not enough to go around. Governments, like families and businesses, face this basic reality. But "claimants" on funds of government seem to hope to overlook it, i. e., too often advocates of spending programs underestimate the persistence of scarcity. Almost anything which can be done by using money could probably be done by government in this country. But *not everything.* Does not the source of much current disappointment lie in failure to recognize the distinction between the "somethings" that *are* possible and the "many things added on each other" that are *not* possible?

Marvels of science and of economic organization which we take for granted do serve us well. But to anyone tempted by the vision of "plenty for all" or that old assertion, "the problems of production have been solved so that inadequacies result from maldistribution," to anyone so attracted, the economist must say, "Don't hold your breath." Wants exceed our ability to satisfy them. Thus we have problems of economizing. So will our grandchildren.

Not long ago we heard of *affluence.* The achieved levels of living of most Americans do vastly exceed anything ever realized, any time, any place, except by a small minority. Obviously, however, many wants which we feel today are not all satisfied.

Some of the shortfall applies to goals which we seek to achieve *collectively,* through government—security in a restless world or on the streets nearby, education, decent provision for all the needy. Some shortfalls are of things which we feel that we ought to get from the results of our work; the income we earn ought to buy more in the market place.

A sizable chunk of the disappointment with what we can get in our private buying power results from the *tax bill* needed to pay for (1) schools and defense and other governmental services plus (2) transfer payments for welfare and Social Security. *Per capita* taxes, including those more or less hidden, have risen (1971 dollars) from under $1,000 in 1961 to around $1,500 in 1971. *This rise of $2,500 for a family of five must certainly help to explain some current lack of satisfaction.* Do we sense improvements in the governmental sector worth this cost?

Aspirations and expectations have risen. For some of us they seem to have gone up more rapidly than our ability and willingness to work, to save, and to raise efficiency in production.

The ballot box has not yet become an Aladdin's lamp. Electoral campaigns spawn promises. They raise expectations. Voting, a rather easy hour's "work," decides elections. But elections do not teach children mathematics, make two blades of grass grow where one grew before, or fill the winter's potholes. "Urban Edens" will not emerge easily or quickly.

The scarcity which underlies life must inevitably affect what we can do through government. In producing goods and services, the political process is no substitute for working. Nevertheless, political oratory — and extravagant talk is not limited to election time—may give the impression that through government "we" can get something for nothing. Congressional opponents of revenue sharing see realities which governors and mayors are hoping to escape.

Hope for Benefits Obtained Cheaply.—Some of the public, however, *can* get benefits paid for largely, or entirely, by others. Here there is a real possibility—but for a minority. This dream, however, has come, both subtly and blatantly, to influence general attitudes toward the use of government. This hope has effects on the financial relations among governments which now haunt the corridors of every legislative body, from small school boards to Congress.

The Santa Claus hope does exert a pervasive influence on the debates about local and state need for dollars. The members of a small group, of a locality or even an entire state, can try to escape the full force of economic scarcity by putting costs on others. The advocate may believe that his goals are the praiseworthy desire to get funds for eminently desirable purposes or persons.

But just as "pure hearts do not make pure air," generosity and compassion do not pay the bills. They do not do the work that creates real income. Is it not human, however, to feel impatient with the constraints of scarcity? "Instant solutions," however, have solved rather little, despite costs which are at times heavy. The typical response to disappointment seems to be to ask for more dollars. To get them, advocates fill the air with more strident insistence that things are wrong, and in crisis proportions. And, of course, someone else ought to be able to meet the cost.

Governmental Boundaries in an Open Economy. — Some disappointment in using state and local governments as instruments for meeting needs arises because intuitively we expect the units to which we attribute the designation "government" to have more *economic reality* than in fact is the case. Wide differences in levels of production (per capita) and of living have been due chiefly to factors other than the differences in things which state governments do. As a result, state lawmakers in imposing taxes have been limited in their ability to "latch on" to valuable differences in services which are provided by state governments. (A few states do finance themselves in part from differences created by *nature,* e. g., severance taxes on natural resources.) Income and wealth are mobile. When a state government does not actively contribute to the creation of income, then taxing the process of income generation has only limited potential unless others are generally doing so.

Much the same may be said of local governments. As areas or regions, the differing relative economic strengths of localities have resulted to limited extent only from government services.

With heavy reliance on local government to provide education and other services, America has developed different levels of local expenditures. Some inequalities became disturbing, then unsatisfactory, then even obnoxious. And they would have become more striking if local governments had been fully autonomous. Terms such as "imbalance" and "mismatch" convey some of the recognition that economic and political (governmental) areas do not coincide.

Political boundaries in an essentially open economy have had only limited economic effect. The results of this separation of economic development from political influence have been immensely valuable as compared with what would probably have resulted if Americans had been freer to use political power to bolster "protectionist" and other restrictive economic practices in state and local areas. But the general economic benefits of rising income have not been expressed so fully in governmental services in some areas as many people have hoped.

Capital "Shortage."—A feeling that this country is amply able to supply new capital facilities seems to have crept into much thinking. Compared with "needs," present and future, conditions are less satisfactory. Americans in recent years have saved on the average (net) around 6 per cent of their after-tax income. These amounts along with corporation earnings kept in the business are too low to satisfy prevailing and developing aspirations.

Some of the strains and difficulties that state and local governments are seeking to deal with reflect the "low" level of saving relative to the "high" level of aspirations for capital goods. State and local governments need funds to finance capital improvements. To get the dollars necessary from the limited supply of funds available in capital markets, governments must compete with others—with electric and other utilities, the housing market, and industrial needs. The amounts, however, will not be adequate to meet the expectations of Americans.

Any *one* individual program (housing, hospitals, schools, utilities, environmental betterment), or any *one* community or state, can hope to escape the limitations set by the supply of new savings. Getting outside assistance offers the possibility. *But not the government sector as a whole!* "Rearranging priorities" can be highly praised. It will not, however, increase total availability.

Population Changes. — Today's stresses and strains in government finance owe much to population changes. Since World War II our population has grown by more than the total of Italy plus Scandinavia.

Imagine what public finances would have been over the last 20 years if school population had not risen by around 25 million!

Children are expensive. Just when family finances are heavily strained, families are expected to pay taxes for a governmentally provided function, schooling, which is expensive. And it is one which most parents hope to have performed on a rising level. Each child is young only once. *His* or *her* chance for good schooling cannot be paid for out of his, the family's, or the country's income a decade later. How natural for parents to press for better schools now!

School outlays (including nongovernmental) have soared. From around

3.4 per cent of Gross National Product in 1950, they more than doubled—to 7.1 per cent—by 1970. This financing represents an enormous achievement. With the lower level of births of recent years, "solution," though unattainable in an ideal sense, ought to be approximated more closely.

Aging also proves expensive. A generation badly hurt by the Great Depression included a large number who had not provided adequately for their retirement. Inflation, of course, has magnified the dollar need.

Movement from country to city reduced the ability of the family to provide for older persons in the form natural through most of history—life on the farm supported by some contribution of effort. Earlier retirement, some quite *in*voluntary, reduced the productive capacity of persons who would continue to consume. Their ability to pay taxes has often been slight. Traditional arrangements would not support the larger numbers in the newer conditions, including inflation. "Government" was to be given key responsibility. Today, much the largest means, of course, is Social Security (Old-Age and Survivors' Insurance). The financing is by federally imposed taxes. But in fact all levels of government are affected by this rapidly rising use of taxpaying capacity. A significant fraction of our taxpaying capacity goes to pay benefits to persons retired. The employer's portion we can think of as either adding to the prices we pay or reducing income; in either case, the taxes paid are not available for schools or policing or airports or eliminating governmental sources of pollution. Per capita over all our population (not per employee), the *payroll* taxes in 1972 will be around $250 (including Medicare) compared with $70 in 1961. A basic economic fact recurs: Resources (taxpaying ability) used for one purpose cannot be used for another. Higher burdens portend more trouble for state-local ability to tax.

Mobility influences government finances. The nation-wide total of state-local spending in this land of diversity will depend upon *where* the people live. Each year many move. High service levels will *attract "users"*; high tax levels will *deter taxpayers*. How much in each case? No good measures are available; the amounts must vary significantly from place to place and time to time. But the basic tendencies will be clear. Competition among communities and states will exert restraining influences—against higher spending and heavier taxes.[6]

Freedom and Spearheads of Progress.—The amount for which people will pay in taxes will depend more than a little upon the benefits they expect to get. Grudgingly, reluctantly, often with vigorous dissent and objection, voters *will* tax themselves and their children. If the issue is one of

[6] Comments about such competition come from people who are dissatisfied with this condition of American public life. (The movement of people in response to welfare aid presents a problem which needs to be distinguished from those for service, such as education.) Is it not bad, critics seem to ask, that people can be free to move in response to service levels and tax costs? One suspects impatience with freedom. Do we not wish, really, to see many others better off than they are able and willing to pay for freely? If so, cannot "we" force everyone to support a higher level of taxes and spending? The "correct" answers are not so simple as may be implied. One suggestion, however, does deserve thought: Perhaps real progress can get some aid from the search for communities with a spending-taxing balance which reflects choice among alternative opportunities. Making government more responsive to the demands of the people, by the very nature of the process of choice, will reveal that probable benefits are not always worth tax costs to everyone. The ability to move either a business operation or a family constitutes one source of freedom; some people benefit from the opportunity to choose a more attractive set of conditions.

paying for services in distant communities or across the nation, will not the enthusiasm be somewhat less?

Does it not stand to reason that the amount of tax money spent, and the quality of services financed, will be greater when the people paying do so for themselves than when their taxes are spread over a whole state or a whole nation of which the particular group is a small percentage? The correct answer to this question is probably nearer to "yes" than to "no." Compared with a uniform average over a large area, more points of progress, more cases of pressing ahead, of initiative and payment for better services, are likely to develop when communities (and states) are able to use their own economic resources for themselves and their children.

Let no one romanticize the virtues of local government. (Nor the federal accomplishment.) Things in many communities are less than ideal as regards public services relative to ability to pay (or poor relative to the amounts actually paid). Voters may be misguided. Many of us would like our neighbors—and people elsewhere in state and nation—to spend differently. But are the things which are financed through state capitols or Washington better per dollar spent than those from local outlays? Sometimes yes, sometimes no. Nothing approaching "proof" can be cited to resolve doubts beyond question.

Where things are *best*, however, local freedom and decision will probably be playing a part. The *best*. Getting voters to submit themselves to taxes is no easy matter, but results must count in the long run. Not everything that someone of goodwill believes to be desirable—not even every added outlay for schools or hospitals—"ought" to be approved in a world of scarcity. Nevertheless, decisions reflecting local choices will lead to examples of good quality which are not to be expected of a more centralized regime with its pressure for uniformity of results.[7]

Welfare Costs.—A big, and unpleasant, surprise of recent government finance has been the growth of welfare costs. The post-World War II growth of personal income (after full allowance for price-level changes) has been widely diffused. Despite the increase in population, one would have expected a drop in the need for welfare aid. The fact that outlays have multiplied testifies, among other things, to the low levels of aid traditionally provided in much of the country. Hopefully, we ought soon to be within sight of "solution" in the sense that legitimate needs would be satisfied without growing outlays. Yet optimism gets little foundation in the record. Five points deserve comment.

(1) The "tax" of 100 per cent (or nearly that much) on welfare recipients' earnings above some point defies rational economics. To have *created* an *obstacle* to what is obviously so desirable—incentive for the needy to try to contribute to support for self and family—scarely testifies to "our" foresight. To have continued such stupidity is even less easily condoned. Awareness of the need for reform leads to hope for better rules.

(2) Equally silly, and inexcusably inhumane, is the incentive for family

[7] The person who is strongly egalitarian may dispute the conclusion. Or he may believe that an average level of X is to be preferred to one of X plus Δ X as some cases are quite a good deal better than the general run. Matters of magnitude and degree must, of course, be considered. But is there not convincing reason to support local opportunity to get significantly above the average? Moves to make education (almost) entirely a state responsibility, with more financing from Washington, would likely hamper the development of more of the best.

break-up. Fathers are pushed out of the home. In the 1930s there may have been good reason to design a program specifically for mothers having no support from an "inhouse" father. Yet we still suffer from a monstrously deforming incubus. Once again, recognition of need seems likely to lead to new rules which will reduce the pressure on fathers to separate from mother and children.

(3) Federal farm programs have done a good deal to shift the residence of the poor—and into areas of more costly welfare aid. Who gave much thought to what would happen to welfare budgets in northern cities as governmental farm programs forced land out of use and encouraged mechanization? Hopefully, what lies ahead in the further displacement of human beings will be less in numbers. The strain on the finances of state-local governments will probably not be accentuated on a scale anything like that due to displacement of humans over the last 20 years.

(4) An underlying economic fact complicates "solutions" of welfare problems. Many people are not very productive. By and large, the American economy pays workers about what their output is worth. Of course, each of us could cite exceptions; some people do get more than the value of what they produce, some less. In general, however, the cost to the employer (fringes included) will be about the worth of what employees produce as reflected in what consumers are able and willing to pay.

Anyone looking at his paycheck, however, sees that as a worker he does not get all that the employer (or the consumer) incurs in cost. Taxes take a chunk. And there are other deductions. For persons who do not produce "much"—because of low skills or poor motivation, inadequacy of tools and other cooperating capital, instability and irregularity of employment, poor management—the net cash will not finance a "comfortable" living. A person's production minus taxes and other deductions may be little over what is needed for a humane standard of living. If he has others to support, a tragically large shortfall may remain.

Our instincts press us to try to finance a level of aid which in terms of the long-run health of the economy will permit conditions for children that are conducive to more nearly satisfactory development of their potential. The nearer we do so, however, the more we encounter a disturbing result: The aid may then approximate as much as many persons can get, and keep after tax, by working. In some cases, e.g., where several members of a family group are dependent, the relief aid may exceed the worth of the output of the head even when he (or she) is working at his (or her) best. When one takes account of the costs of travel and other matters associated with holding a job, and the trouble in getting back on welfare if one leaves, then inherently unwelcome elements must frustrate policy actions; the economic reality of low productivity conflicts with human needs.

No quick "solution" is in sight. But over a not-so-very-long run, helpful progress on the productivity aspect can come from a combination of such factors as more and better training, larger amounts of capital per worker, better management, higher total demand for labor, child care facilities, improved health. (One general economic benefit from Medicaid ought to be better health for some of the working population.)

(5) "Man is the source of many of his own worst difficulties." This sad truth helps to account for another part of the welfare problem. Federal and state minimum wage laws condemn persons of low skills to unemployment and penury. The laws dictate that many persons of low

productivity cannot be employed. (Union pressure for higher wages exerts similar forces, but government is not so clearly responsible for the employment-hampering results.) The structure of the economy is not permitted to adjust and adapt to employ productively one kind of labor which is relatively plentiful. Entrepreneurs who might create employment opportunities are in fact forbidden by law from doing so.[8]

Measuring Results Relative to Costs.—Obviously, much of the frustrating uncertainty and complexity of government spending and taxes would melt away if results could be measured. Comparison of benefits with direct and indirect costs of taxes would then show the courses of wisdom. Unfortunately, no hope of large and quick progress can be justified. Inherently, some things we seek through government spending defy measurement.

The large element of personal services in the provision of governmental output involves a type of expense which raises more, apparently, than can be offset by improvements in productivity. Unionization of state-local employees adds to the upward pressure of costs. Assertions that productivity in government does not improve probably oversimplify. Nevertheless, the opportunities for the substitution of capital for labor, and for the utilization of facilities which embody advancing technology, do seem to be lower than in many parts of the economy. But we can keep an open eye for ways to take advantage of the improvements which someone succeeds in making available.

When campaigning for election, a state or local political leader will deplore the inadequacy of the accomplishments of the group in power. He will promise more. But to actually deliver more, he must have more to deliver. And the public must deliver more to him—in taxes—for him to spend. Here are elements of *crisis*—disappointment fostered by the political process. The real crisis reflects, more than we wish to admit, a failure to make explicit what is true in government as in the market place—not everything is worth its cost. Truly responsive government, however, must be built upon this reality, *not* upon "desires," "needs," or "requirements" separated from the costs. The alternative which *must* be sacrificed to pay for results must be put into the balance. And taxes have effects, adverse effects, which call for more inquiry.

To improve government, with all its vast significance for life, we need better means of relating benefits and costs. Can we not do more to improve the "controls" on the growth of spending? As higher taxes and larger federal grants shift more of the economy to the state-local sector, what are the results? Is the state-local sector, on the whole, the one that is most productive and most efficient and most humane? Though many excep-

[8] The problems of federal, state, and local finance which result to some extent from teen-age (and other) unemployment, and from property and welfare costs—these problems are exacerbated by minimum wage laws. Not overnight but over time, man by modifying statutes could undo some of the damage that he now does to his fellowmen (and women). This conclusion would receive widespread agreement among professional economists. Jobs would be created as entrepreneurs saw profit potentials. Lest a valid point of importance be caricatured, and then rejected in a form which is not intended, the true position ought to be stated. Not *all* results of minimum wage laws are bad. Not *all* teen-age unemployment results from minimum wage laws. General relaxation of state and federal laws would not at once double the jobs available. But some difficult problems of public finance *are* made worse by laws which could be modified and humanized. The problems will be accentuated if the minima are pushed higher.

tions will be found to any generalization, I suggest that there is a presumption against such a shift.

Concern for the Economic Base

As already mentioned, *mobility of capital* has become a concern affecting governments. The base of economic life has become less tied to specific locations than in the past. In an economy consisting largely of agriculture and extraction (mining and forestry), natural conditions go far to determine basic locations of production. Then, following the choices made for them, satellite and related servicing activities settle nearby.

Manufacturing, however, has an element of freedom. Its growth has reduced the force of land characteristics in determining location. The beginning of this emancipation was not in our generation, not by any means. But since World War II, much of the *growing* elements of the American economy, much of the element of dynamism, has consisted of enterprises which can hope to do about as well in any one of several locations.

Differences in the "packages" of taxes and governmental services can influence decisions about where to locate initially and where to expand or contract. Whatever the magnitude of state-local taxes as a cost element, government officials act with this sort of competition in mind. Concern for their economic base affects what localities and states do. Here lies a reason which is frequently cited for broader-area financing of government, i.e., for taxes which apply over a large area so that localities (or states) cannot compete on a basis of tax differences.

Time limits prevent adequate development of my general conclusions. Competition in government, as I noted earlier, has merits as well as limitations. Transfers, redistributive spending and taxes, must generally apply over broad areas. This function belongs predominantly to the national government, not to states and localities.

Concluding Comments

State-local tax systems differ so much that I hesitate to venture "conclusions." Compared with federal taxes, the better of existing state-local systems rank high, it seems to me, as *regards marginal amounts of tax.* In comparing greater use of state-local taxes with federal (as for financing larger grants), the potentials of state-local sources as they could be developed lead to a considerably more favorable picture than is usually painted. In any case, however, the need for improvement of state-local tax systems deserves intelligent, objective and sustained support.

[The End]