Foreword

. . . [W]ith the change of circumstances, institutions must advance also to keep pace with the times. We might as well require a man to wear still the coat which fitted him when a boy, as a civilized society to remain ever under the regimen of their barbarous ancestors.

—THOMAS JEFFERSON

Thomas Jefferson waxed eloquent over the need for governmental institutions to reflect the times. And quite clearly, the institutions of local government are doing so in many areas. Witness the myriad of changes in the composition, quality, and quantity of public services: computers in schools, Internet access and videocassettes in public libraries, waste-to-energy plants, senior centers, after-school programs, streamlined management structures, and greater diversity in the workforce. The list goes on and on.

Yet, the revenue-raising institutions of most local governments as they enter the 21st century bear a greater resemblance to their mid-20th-century counterparts than does the expenditure and service side of the fiscal equation. The primary source of local tax revenue remains the property tax, augmented in many communities by sales taxes. Except in a few local governments in a few states, income taxes remain bit players on the local fiscal stage.

It is hardly news that since at least the 1970s, the property tax has been under major assault from broad economic and demographic changes. Beginning in the 1980s and with accelerating momentum into the late 1990s, the sales tax also has come under assault from dramatic economic, demographic, and, increasingly, technological trends. Instead of abating, these trends are speeding up as we enter the 21st century.

These trends have profound implications for local administrators and the communities they serve. They pose a substantial long-term threat to the basic fiscal foundation of local governments. Local administrators and their legislative bodies must be concerned that these trends—picking up on Mr. Jefferson's metaphor—are slowly but surely putting local governments in a fiscal straitjacket.

Furthermore, this is not just a fiscal question. If communities increasingly are unable to finance their services from local sources, their ability to retain a desirable degree of local decision-making authority also may rest on a fragile foundation. The following article by Thomas Bonnett makes these and related points poignantly clear.

—Michael Lawson, Deputy Director
Research and Development, ICMA

Is the New Global Economy Leaving State/Local Tax Structures Behind?

Thomas Bonnett

Prominent economic, social, demographic, and technological trends are threatening to erode the tax revenues of states and cities. The mainstays of these tax systems are the income, property, and sales taxes. Together, in fiscal 1994, they generated 75.9 percent of total state and local tax revenues. Each is a prominent revenue source for state and local governments: again in fiscal 1994, the property tax generated 31.5 percent, the sales tax 23.8 percent, and the personal income tax 20.6 percent of total state/local tax revenues.

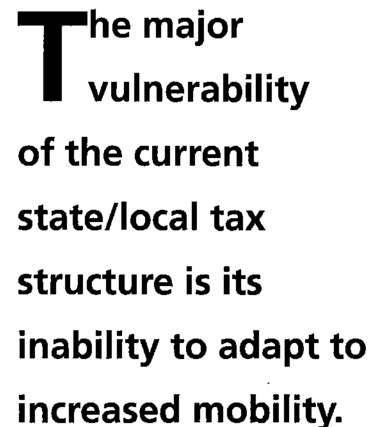
The most significant fiscal trend over the past 20 years has been the declining share of federal support to state and local governments, which has placed a much greater burden on current state and local taxes. Over the 1990–1995 period, federal grants-in-aid to state and local governments averaged 21.5 percent of their total spending. This is well below the 26.5 percent peak, which occurred in 1978. Consequently, state and local governments have had to rely much more on their own tax revenue sources to generate sufficient revenue to provide the services required by the public. Further, the recent trend of Congress's pushing more responsibilities onto state and local governments will place additional burdens on the current state/local tax structure.

If these two trends continue, federal grants-in-aid to state and local governments will likely remain at modest levels for some time, and burdens will likely increase. This prospect heightens the importance to state and local leaders of maintaining a state/local tax structure that will continue to generate adequate revenues with which to support valuable public services. The continued effectiveness of the tax structure is essential to maintain the autonomy of state and local governments. State and local leaders concerned with the independence and responsiveness of their governments should be sensitive to the stability of the state/local tax structure.

When the current state/local tax structure was constructed, most local and regional economies were tightly bound to geography. In that era, most people worked, shopped, and lived in the same community. In these "closed" systems, jurisdictions had a relatively easy time taxing income and consumption to raise sufficient revenue to support public services. The global economy today, however, is an open system of economic production and consumption. The major vulnerability of the current state/local tax structure is its inability to adapt to increased mobility.

Capital has always been mobile, but in the global economy, it can speed from London to Hong Kong to New York in seconds. Ideas, information, and knowledge are mobile and have become important factors of production in the new global economy. It is a cliché to talk about a shrinking world, but transportation and telecommunications costs throughout the world have plummeted in this century. International trade between 1980 and 1995 grew twice as fast as the growth in world output. In 1970, about 25 percent of the total world output was traded internationally; that figure is projected to be 50 percent in 2000.

The mobility of the factors of production in the modern economy has enabled global firms to comparison-shop around the world for advantageous locations for new industrial plants. Job-hungry governments have responded by bidding for business. Two decades ago, industrial recruitment was considered a regional competition—the Sunbelt versus the Rustbelt. Today, industrial recruitment is an international competition.



The mobility of capital has enabled business to seek tax preferences aggressively from state and local governments. The net effect has been a reduced share of tax revenues from business. Each level of government in the United States collects a smaller share of its total tax revenue from business today, compared with 1946. The challenge of taxing income and capital is a global problem and one that grows more difficult with each passing day.

The current tax structure was built decades ago, when the industrial economy produced tangible goods. The shift to the new service economy is the best-documented challenge to the current tax structure, but other social, demographic, and technological trends pose difficult challenges as well. The change from a manufacturing-based economy, the changing nature of work, the shift to electronic commerce, the mobility of firms and the resulting interjurisdictional tax competition, the deregulation of the telecommunications and electric industries, and the aging of America are trends that together could jeopardize the future viability of the current state/local tax structure. Each of these trends has important tax implications.

Adolescent Gorilla Dressed in Baby Clothes?

The most immediate threat to the state/local tax structure may be policymakers in Washington, D.C. As this issue of *Public Management* goes to press, legislation is pending that would prevent states and localities from taxing the Internet. According to an article in the February 1998 issue of *Governing* magazine, the rationale provided by a Senate cosponsor is that he wants to ensure that state and local governments don't "choke this baby in its cradle."

Given that Internet growth has been nothing short of phenomenal in recent years, Jonathan Walters of *Governing* responds that ". . . the infant in question here is more like an adolescent gorilla who's been nursing a cocktail of steroids. In other words, choking this baby is pretty much out of the question; just try to steal its rattle, and it will probably rip your arms off." Walters goes on to say that "the Internet does not need to be protected from state and local governments; state and local governments need to be protected from the Internet."

The so-called "Internet Tax Freedom Act" would preempt states and localities from imposing new taxes on the Internet. According to sponsors, it would not affect taxes currently being collected by state and local governments. This interpretation, however, remains in serious dispute. To localities and states, a sales tax on a good (or service) purchased over the Internet is not a new tax at all. The method for purchasing the good has changed, but the good itself is the same. But this interpretation may not hold up as the words "new" and "collected" are defined as the legislation wends its way through Congress or in the courts, should it become law. Alas, the adolescent gorilla may get its way after all.

At its meeting in January, the ICMA Executive Board endorsed a set of recommendations of ICMA's Governmental Affairs and Policy Committee. One of those recommendations was to oppose federal preemption of state and local authority, including federal preemption regarding Internet taxation. Although ICMA does not lobby, by providing information to local administrators and, through them, to councilmembers and other elected officials, the Association hopes that a more enlightened discussion of public policy issues will occur.

—Michael Lawson, ICMA

Economic transformation. The magnitude of the shift over the last half-century from an economy based on manufacturing goods to one dominated by knowledge-based and personal services often is not well understood, but it poses several challenges to current tax policies. In 1959, services constituted less than 40 percent of the gross domestic product (GDP), while goods production constituted roughly half. In 1994, services came to almost 65 percent of the GDP, while goods production accounted for about 37 percent. In short, there has been a dramatic shift in how the modern economy creates wealth. State and local leaders may ask, in this context, how well the current tax system matches the modern economy. Specifically, they may ask how the current sales tax system corresponds to the fastest-growing sector in the economy.

Two specific tax questions are posed: Should personal services be included in the sales tax base, and is the property tax biased against capital-intensive firms? There may be less rationale to limiting the sales tax to tangible goods while services—the growth sector of the economy—remain untaxed or are inconsistently taxed. Similarly, the continued reliance on the property tax as the primary source of funding for local governments may pose a heavy burden on goods-producing firms and capital-intensive industries. The effect of both policies may violate the notion of horizontal equity in taxation, impose burdens on narrow tax bases, distort private economic decision making, and hinder economic development. The issue of reforming the tax structure to achieve tax neutrality among firms and to promote economic development will merit further study.

Changing nature of work. The increase in global competitiveness has led to major corporate downsizing; advances in computing and telecommunications technologies have enabled such organizational restructuring as telecommuting and decentralizing of headquarters operations; and public sector innovation following this pattern of reengineering has fostered other changes in how work is being organized. Each of these developments has tax implications for state and local governments.

Electronic commerce. Electronic commerce offers both boundless opportunities for, and grave threats to, the public sector. State and local governments may lag behind the private sector in implementing the latest information technologies that enable electronic funds transfer, electronic benefits transfer, electronic data interchange, digital signatures, and "smart cards." An increasing number of public sector leaders understand that these technologies hold tremendous prospects of improving services and achieving greater efficiencies. But implementing these improved services and efficiences in the public sector is a difficult task.

Electronic commerce also poses a long-term threat to the current tax system. The threat is that consumers will increasingly use electronic media for purchasing goods and services—circumventing conventional sales taxation—and will shift earned income to other jurisdictions, either minimizing or evading conventional income taxation. Income and consumption are no longer constrained by geography.

The traditional definition of "nexus" for sales taxation, that of having a physical presence in a state, is rapidly becoming an antiquated concept as electronic

commerce emerges in new markets. Unless Congress redefines the term nexus, electronic commerce will erode the revenue stream from state/local sales taxes. Although this potential threat is a serious one, the recent discussions between the mail-order catalog industry and the states have presented an excellent model for resolving this political conflict and a basis for measured optimism that this resolution can be achieved with enlightened private sector leadership. Indeed, if the states can negotiate an agreement with the largest mail-order firms to collect sales taxes on purchases made across state boundaries, electronic vendors could be persuaded to follow this path.

Firm mobility and interjurisdictional tax competition. State and local officials are under increasing pressure to grant tax preferences that erode tax neutrality among competing firms. That economic development trend has been bolstered by advances in telecommunications and information technologies, the increased mobility of capital, the changing nature of work, and the ability of firms and individuals to locate wherever preferential tax treatment is provided.

Deregulation of the telecommunications and electric industries. Allowing competitive entry in these regulated industries will end the practice of specialized taxation of monopoly providers. Achieving tax equity will force state and local governments to experience substantial tax shifting. Considerable hardship is expected for taxing jurisdictions that rely heavily upon existing electric-generating facilities to pay local property taxes.

Aging of America. This well-documented demographic trend may result in major shifts in aggregate consumption patterns, thus diminishing sales tax revenues, and may create pressure for broad reforms in senior tax preferences. The growing elderly population may reduce public sector revenues because older people tend to spend less than the average working population in general, and spend more on such services as health care that are not often taxed. Further, political controversies over the vast array of senior tax preferences could become more divisive in the future.

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In addition to these major threats, two immediate policy challenges to the current state/local tax structure loom on the fiscal horizon.

Federal tax reform. Congressional proposals for a flat tax and a national retail sales tax would force states to undertake major revisions of their sales and personal income tax systems. Both proposals would eliminate state and local tax-exempt bonds, significantly increasing the cost of state and local capital investment. It would be difficult to overstate the havoc that would be caused to the state/local tax structure if federal tax law eliminated deductions for mortgage interest, state personal income taxes, and local property taxes.

Federal preemption of state or local taxes. Congress has been inconsistent in responding to the needs of state and local governments. The Unfunded

Mandate Reform Act of 1995 has been lauded by state and local leaders. On the other hand, the devolution of domestic programs, as in the Temporary Assistance for Needy Families Act of 1996, has been viewed by some as a tremendous opportunity and by others as an insurmountable burden. In the area of federal preemption of state or local government authority, state and local leaders are clearly displeased by the current trend.

The Clinton administration's recommendation that Internet transactions not be burdened by new taxes and the strong congressional interest in the Internet Tax Freedom Act—which would preempt state and local taxation of electronic commerce via the Internet—threaten to erode the traditional sales tax revenue base.

Now, in the seventh year of economic expansion—the national unemployment rate is 4.3 percent, the lowest since 1973—the current state/local tax structure is generating an adequate revenue stream to fund essential public services. Yet, the long-term threats and immediate challenges to the existing tax structure are very serious.

The transformation to a new service economy should provoke a thoughtful revision of the current tax system. The tax structure built in the Industrial Age no longer matches the modern economy, and the mismatch is growing wider. The changing nature of work from corporate downsizing, telecommuting, and public sector innovation represents opportunities as well as challenges to the leaders of state and local governments.

As we enter the Digital Age, the prospect of electronic commerce may be the most visible long-term threat to the existing state/local tax structure. The advent of electronic commerce liberates consumption from geography and heightens capital mobility. The mobility of firms forces interjurisdictional tax competition. These trends make it more difficult to tax capital-intensive firms and business properties fairly. The new era of deregulating the telecommunications and electric industries also poses extraordinary burdens on state and local governments.

On the horizon, the aging of America will shift the relative tax burdens among the age cohorts. The growing elderly population will consume less than the working-age population and will spend a large share of its income on services like health care, which often are not taxed. In addition, the controversy surrounding granting a full array of senior tax preferences will escalate as the demographic shift becomes more pronounced and as the champions of generational equity gain more support among the working-age population.

Taken together, these economic, social, demographic, and technological trends threaten to imperil the viability of the state/local tax structure. If not confronted directly by state and local leaders working closely with Congress, the viability of the state/local tax structure could be undermined, jeopardizing state autonomy and local independence in the future. PM

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This article is adapted with permission from the executive summary Is the New Global Economy Leaving State/Local Tax Structures Behind, *prepared by the National League of Cities, National Conference of State Legislatures, and the National Governors' Association.*