Meeting: Local Taxes Advisory Task Force Agenda – Public Testimony

Date: September 27, 2023

Agenda

- Welcome and introductions (Chair Marquart)
    - Name, affiliation, and a fun fact about yourself
- Overview of process for public testimony (Audel Shokohzadeh)
- Public Testimony
- Adjournment (Chair Marquart)

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OPINION EXCHANGE

Local sales tax proliferation is lousy policy

It creates a domino effect of inequality and "fiscal zoning."

By Steve Elkins

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Minnesota's cities and their property taxpayers are under severe stress because of the same inflationary pressures faced by Minnesota businesses — compounded by the need to make catch-up infrastructure investments that were postponed during the pandemic. At the same time, the property tax burden has shifted from businesses to housing as the value of homes skyrockets while the value of offices plummets due to the rise of teleworking.

To cope, cities are searching for alternatives to the property tax to raise revenue. Many Minnesota cities have been attracted by the lure of municipal sales taxes.

Several of the largest cities in the state were granted authority to enact small municipal sales taxes as far back as 1970, including Minneapolis, St. Paul, Duluth and Rochester. Since then, other cities have sought legislative approval to fund their infrastructure through temporary municipal sales taxes, which must also be approved by local voters.

A relatively small number of these Local Option Sales Taxes (LOST) have been approved by the Legislature over the years, mostly for small cities in greater Minnesota to fund local needs generated by seasonal visitors to their communities. However, over the past few years, the Legislature has been inundated with requests for sales tax authority from cities large and small, and from every corner of the state, all seeking to reduce their reliance on property taxes. The amount requested has

exploded from $226 million in 2017 to $699 million in 2022 to requests from 35 cities totaling over $2 billion so far this year.

What makes this option so appealing to cities?

Cities prefer a local sales tax over a property tax hike because it "exports" much of the tax burden to nonresidents. If your city has a regional shopping center it draws customers from surrounding communities. When Edina, home of the original regional shopping center, Southdale, requested its local option sales tax, it estimated that 55% of the tax would be paid by residents of other cities. If my city, Bloomington, home of the Mall of America, were to enact a local option sales tax, it's estimated that 75% of the sales taxes would be paid by nonresidents.

This is the *only* reason any city ever wants its own local sales tax. Sales taxes are both regressive and volatile. Property taxes are less regressive (especially after progressive tax credits are considered) and they are a city's most stable revenue source. However, a city's own voters and businesses have to foot the whole property tax bill.
The first public policy problem with this strategy should be evident: It is inequitable, favoring cities with a strong retail base over cities without one. There will be winners and losers. When MnDOT built the Hwy. 371 bypass around Brainerd, all the regional big box retail migrated to the new Hwy. 371 retail strip in neighboring Baxter. Guess which city now has a local option sales tax?

The second problem is that municipal planning and zoning strategies are influenced by the mix of taxes available to cities, a phenomenon known as "fiscal zoning." Municipal finance expert Michael Pagano famously compared zoning strategies for cities in three different states with different municipal finance laws. He found that cities zoned to attract commercial development when they were dependent on property taxes; particularly for office buildings when a payroll tax was in play; and for high-volume retail in sales-tax-dependent states.

Not only did sale-tax-dependent cities over-zone for retail, but they also consciously zoned for retail at the periphery of their cities to maximize the collection of sales tax revenue from surrounding areas.

On a visit to Salt Lake City, I noticed that there were car dealerships or big box stores adjacent to many of the region's light rail stations. When I asked the development director in one suburban city why this was so, her answer was that these uses provided the highest sales tax yield. The city didn't

care that these uses contributed very little to transit ridership — that was the regional transit agency's problem.

On a visit to Florida, a state that relies heavily on sales taxes paid by tourists, I couldn't help but notice how many vacant store fronts there were in local strip malls. The regional development official leading that field trip explained that south Florida was "over-retailed" by at least 30% because of municipal competition for sales tax dollars.

In these states, big box retailers pit cities against one another to extract tax incentives designed to influence store location. Then, when the financial incentives have expired, the retailer abandons the first store and builds a new one in the next city, leaving abandoned big box stores littering the landscape.

Couldn't happen here? Duluth, a city with a local option sales tax, granted Costco a total of $2 million in tax abatement subsidies in 2020 to build a store near its boundary with Hermantown. The opportunity to garner sales tax dollars from the surrounding region was openly discussed during the City Council meeting where this subsidy was approved.

The Legislature first implemented a sales tax as part of the "Minnesota Miracle" in 1967. Wide disparities in the strength of local property tax bases among school districts had translated into huge per-pupil disparities in school district funding. When the Minnesota Supreme Court ruled that this violated the state Constitution's requirement for a "uniform" system of public education, the state sales tax was enacted to underwrite the transfer of education finance from local property taxes to the state general fund budget (where the sales tax's regressivity can be offset by the progressivity of our state income tax structure).

It would be far more appropriate to alleviate the general pressure on local government property tax levies by using state sales tax dollars to fund increased local government aid to cities, counties and school districts statewide, and by providing "circuit breaker" tax credits to individual homeowners and renters stressed by property tax increases — measures which the Legislature is poised to enact.

As a Bloomington resident, I would selfishly love it if Bloomington could use sales tax dollars from the Mall of America to buy down my local property taxes. But I know from observing the experience of other states that a proliferation of municipal sales taxes would, over time, seriously degrade our quality of life.

The late Sen. Russell Long of Louisiana famously said "Don't tax me; don't tax thee; tax the fellow behind the tree." However, you will not find that dictum on any listing of exemplary taxation principles. The use of sales taxes should be limited to government bodies that can't manipulate zoning polices to chase sales tax revenue.

Steve Elkins, DFL-Bloomington, is a member of the Minnesota House. The views expressed in this article are strictly his own.

Local Option Taxes

Whitney Afonso
University of North Carolina at Chapel Hill

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Introduction

No government can exist without taxation. This money must necessarily be levied on the people; and the grand art consists of levying so as not to oppress.

Frederick the Great

There are many types of local option taxes (LOTs) available to municipalities in the United States. The jurisdictional eligibility and discretionary authority of LOTs varies tremendously from state to state. Despite the diversity of LOTs, they can typically be characterized by three features. First, a LOT usually requires approval from residents via a referendum before the local government can levy it (Beale et al., 1996). Second, LOTs are not universally levied within the state. Local governments have the choice of whether to levy them. Third, the revenues are controlled at the local level (Goldman & Wachs, 2003).

LOTs are increasingly important sources of revenue for municipal governments in the United States. The growing reliance on LOTs may be attributable to restrictions imposed by tax and expenditure limits (TELs), the political palatability of LOTs versus other local taxes such as the property tax, greater revenue-raising capacity, and increased local autonomy. Other potential advantages include diversifying the revenue portfolio of local governments, exporting the tax burden to nonresidents, and ensuring that residents support the tax and associated expenditure by requiring a public referendum. There are, of course, potential disadvantages to reliance on LOTs, such as higher local tax burdens, vertical and horizontal competition with state and overlapping local governments, competition with neighboring jurisdictions, exacerbated fiscal disparities between jurisdictions, and greater inequity. Thus, the choice of tax portfolio entails local leaders choosing the right tax mix for their communities and considering potential consequences (Nechyba, 1997).

This chapter proceeds with a discussion of the evaluation criteria for LOTs. That is followed by a discussion of local option sales, excise, and income taxes. Next it discusses the

impact of the pandemic on LOTs. It concludes with a brief discussion of LOTs and possible areas for future work.

Evaluation of LOTs

Standard Criteria

The most common criteria for evaluating taxes are efficiency, equity, adequacy, feasibility, and transparency. Evaluating LOTs entails additional considerations, including promotion of local autonomy, interjurisdictional competition, and vertical competition with the state (Bird, 2001; Brunori, 2020; Swianiewitz, 2003). This section briefly discusses tax criteria in the context of LOTs.

Economic efficiency dictates that *good* taxes will minimize the distortions they create on firm or taxpayer behaviors. Taxes change the price of goods and services and the supply of labor and capital. The change in these prices can distort economic decision making, which will, unless correcting for market failures, lead to inefficiencies. Government should strive to avoid creating inefficiencies. In fact, the U.S. Joint Committee on Taxation (2017) notes that a "less efficient allocation of labor and capital resources leaves society with a lower level of output of goods and services than it would enjoy in the absence of the distortions caused by the tax system" (p. 4).

In contrast, equity is a criterion that considers the fairness of a tax. Equity is typically addressed by the ability-to-pay principle and the benefit principle. The ability-to-pay principle, as the name suggests, considers the taxpayer's ability-to-pay a tax. Equity in this context has a horizontal and a vertical dimension. A tax that is horizontally equitable places an equal burden on all those with the same ability-to-pay. Vertical equity introduces the idea that taxpayers with different abilities-to-pay should have different effective tax rates. A regressive tax is one whose effective rate grows as income decreases. A progressive tax is one whose effective rate grows as

income increases. A proportional tax has the same effective rate for all payers. While many facets of assessing the fairness of a tax are challenging, deciding on what determines ability-to-pay is one of the most challenging. (Should it be determined based on wages? Wealth? Number of children? Cost of living?) The benefit principle is more straightforward. It dictates that the tax burden should be correlated with the benefits received from the service provided by the revenues. This principle is typically used for public goods that resemble private goods, like utilities and public transportation.

The adequacy of a tax considers whether it produces enough revenue to finance government. This can be thought of in many ways, but two of the primary ones are revenue production and stability. Revenue production is simply how much revenue can be generated by a tax instrument at a reasonable rate. The fiscal disparities of revenue capacity between local governments are also an important factor when considering adequacy. Stability considers the predictability of the tax's revenue. This is especially critical for municipal taxation since municipalities must balance their budgets and, unlike the federal government, do not have the option to deficit spend, even during economic downturns.

Taxes must also be administratively and politically feasible. It is preferable for taxes to be easy and inexpensive to administer and collect. They also must be politically acceptable to municipal leaders and residents. There are some factors that can lead to increased political feasibility, such as the ability to shift a tax's burden to nonresidents, the earmarking of revenues for popular programs, or a lack of transparency that prevents the full burden of a tax to be visible to the taxpayer. Transparency, as a criterion, suggests that good tax policy prioritizes transparency in the adoption and administration of taxes (including compliance requirements).

Ideally, this transparency extends to keeping taxpayers well-informed about the true extent of their tax burdens (Mikesell, 2016).

Additional Criteria

Local government tax autonomy "focuses on the degree of discretion a local government has over the base, tax rates, and other attributes of the taxes it has at its disposal" (Reschovsky, 2019, p. 1). It is frequently noted how critical the property tax is to maintaining local autonomy in the U.S. federalist system (Brunori, 2020; Friere & Garzon, 2014; Mikesell, 2016). However, the availability of other local taxes and fees—along with local governments' discretion in levying them, setting the rates, and choosing the tax bases—is critical in the wake of the proliferation of TELs. Therefore, the more discretion the municipality has in choosing which taxes to levy and how to levy them, the greater the degree of local autonomy.

Interjurisdictional competition combines many elements of the above criteria. At the local level, the effects of differences in tax portfolios, bases, and rates between neighboring and peer jurisdictions can lead to inefficiencies and market distortions. For example, it is considered a best practice for local governments to focus their taxes on immobile capital so that once the tax is levied, it cannot be avoided by moving elsewhere (Bird, 2001). Vertical competition is also a common concern with local taxes. Typically, local governments rely on the same tax instruments as their overlapping governments (i.e., municipalities, counties, and special districts), but they often rely on the same instruments as the state, too. There is evidence that when two levels of government levy similar taxes on the same tax base, the combined rate is inefficiently large (Sobel, 1997). Similarly, this can lead to fiscal illusion and decreased transparency (Afonso, 2014).

Common LOTs

This section presents an overview of some of the most common LOTs available to municipalities in the United States. A selection of LOTs are briefly discussed with examples from across the country, including the relevant literature and the application of the tax criteria.

Local Option Sales Taxes

Table 1 presents the states that permit local governments to adopt sales taxes. Thirty-seven states grant levying power to local governments, but only 32 states permit municipalities to levy them. Additionally, there is a wide range of jurisdictional eligibility and discretionary authority among the states (Afonso, 2017a). For example, in Alabama all municipalities can levy a local sales tax and there are no restrictions on the rate. In contrast, only tourism-dependent jurisdictions in Montana can levy a sales tax, and there is a rate cap of 3 percent. However, as of 2021 Montana is considering expanding jurisdictional eligibility for the local option sales tax, which would allow local governments to levy a sales tax of up to 4 percent on nonessential luxury products and services. The proposed sales tax would not tax groceries, medicine, or gasoline, but it would tax clothing, rental vehicles, and purchases made in restaurants and bars (Mitchell, 2021).

The reason for exemptions is that sales taxes are regressive and put a larger effective tax rate on lower-income taxpayers. As a result, many state and local governments exempt necessities like food and prescription drugs from the sales tax base. However, these exemptions also narrow the tax base, leading to less revenue, a need for higher tax rates, decreased efficiency, and lower adequacy. Exempting necessities makes the tax more elastic and less stable. It may be argued that sales taxes "tax too few household services [and] exempt too many household purchases of goods" (Mikesell 1997, p. 149).

Table 1

Select LOTs Available by State

State	Sales Tax	Meals Tax	Occupancy Tax	"Soda" Tax*	Marijuana Tax	Tobacco Tax	Income Tax**
Alabama	M, C		M, C			†	M, C
Alaska	M, C		M, C		M, C	M	
Arizona	M, C, O		M		M		
Arkansas	M, C	M, C	M				
California	M, C, O		M, C	M	M, C		M
Colorado	M, C, O		M, C	M	M, C	M	M
Connecticut					M		
Delaware			M, C				M
Florida	C, O	M, C	M, C				
Georgia	M, C, O		M, C				
Hawaii	C						
Idaho	M		M				
Illinois	M, C, O	O	M, C		M, C	†	
Indiana		M, C	C				C
Iowa	C		M, C				C, O
Kansas	M, C		M, C				M, C†††
Kentucky		M	M, C				M, C, O
Louisiana	M, C, O	O	M, C			M, C	
Maine							
Maryland		C	M, C			†	M, C
Massachusetts		M, C	M		M		
Michigan		M, C	M, C				M
Minnesota	M, C		M, C				
Mississippi	M, C, O		M, C				
Missouri	M, C, O		M, C			†	M
Montana	M, C		M, C		C		
Nebraska	M, C		M, C			M††††	
Nevada	C, O		M, C				
New Hampshire							
New Jersey	M	C	M		M		M
New Mexico	M, C		M, C				
New York	M, C, O		M, C			M	M, O
North Carolina	C, O	M, C	M, C				
North Dakota	M, C, O		M, C			M, C	
Ohio	C, O		M, C			C	M, O
Oklahoma	M, C, O		M, C				

Oregon		M	M, C		M		O
Pennsylvania	M, C		M, C	M		M	M, O
Rhode Island		U					
South Carolina	M, C, O	M, C	M, C				
South Dakota	M						
Tennessee	M, C		M, C				
Texas	M, C, O		M, C				
Utah	M, C	C	M, C				
Vermont	M	M	M				
Virginia	M, C, O	M, C	M, C		M	M, C	
Washington	M, C, O	C	M, C	M			
West Virginia	M, O		M, C				M
Wisconsin	C, O	O	M, C				
Wyoming	M, C, O		M, C				

Note. M = municipal tax; C = county tax; U = uniform tax (not optional); O = other tax (a special district, frequently a "resort area"); X = levying new taxes is no longer authorized, but taxes implemented under prior laws are still in effect. The local excise taxes are only considered permitted when they tax the good outside of the sales tax. In many states, there are additional restrictions on which local governments can levy these taxes. This table only reports whether each tax is permitted, not whether it is permitted by all jurisdictions. Information consolidated from Afonso (2017a, 2019), Avalara MyLodgeTax (n.d.), Tobacco Health Legal Consortium (2016), Urban Institute (n.d.a, n.d.b), Walczak (2017, 2019), and State Departments of Revenue.
[a] These are the states where local governments have implemented a soda tax. With the exception of California, only one jurisdiction in each state has a soda tax.
[b] This includes states that permit localities to adopt a tax on wages, a payroll tax, or a tax on interest and dividends.
[c] Kansas cities and counties may tax gross earnings derived from money, notes, and other evidence of debt having a tax situs in such county. Kan. Stat. Ann. § 12-1,101.
[d] Municipalities or counties may impose sales and use taxes on any item that is taxable by the state (Neb. Rev. Stat. § 13-2813). Omaha imposes a 3 percent occupational-privilege tax on the manufacturing and sale of tobacco products.

Another common restriction on local autonomy is the earmarking of revenue from local sales taxes for specific functions, such as transportation, public schools, and economic development. There tend to be fewer earmarked sales taxes for municipalities than for counties. For example, in California there are no earmarked sales taxes for municipalities, but counties can levy sales taxes for transportation. While this suggests greater discretionary authority for municipalities, it is not straightforward. It typically signals fewer options for municipalities. Examples of states that allow their municipalities to levy earmarked local sales taxes are

Mississippi (transportation), West Virginia (pension relief), and Texas (property tax relief, economic development, street maintenance, and other costs) (Afonso, 2017a). There is some evidence on the impact earmarks have on expenditures and outcomes, but more analysis is warranted (Afonso, 2015a; Kanaan et al., 2021).

Economic theory suggests that an increase in sales tax rates will decrease the size of the tax base. One mechanism by which that decrease occurs is the mobility of the sales tax base. "Local governments can try to attract retail sales by keeping sales tax rates low and encouraging residents of other jurisdictions to cross border shop. This predatory behavior must be balanced against the governments' desire to raise revenues." (Luna, 2004, p. 43). Research has shown that local sales tax revenues and municipal sales tax rates are affected by both vertical competition (countywide rates) and horizontal competition (neighboring jurisdictions' rates) (Agrawal, 2016; Burge & Rogers, 2011). In fact, the literature suggests that a 1 percentage point increase in tax rate is associated with a decrease in per capita sales along the state border of 1–7 percentage points (Sjoquist, 2015). This reinforces the economic inefficiencies of local sales taxes, which is why public officials have to balance the need for revenues against the distortions such increases create, as Luna has pointed out.

Similarly, research has presumed that urban jurisdictions or regional retail centers have greater revenue-raising capacity (Burge & Piper, 2012; Burge & Rogers, 2011; Rogers, 2004). However, there is evidence that the fiscal disparities created by local sales taxes are not as great as presumed because the revenue capacity of sales taxes might not be correlated with property tax bases (Afonso, 2016; Wang & Zhao, 2011; Zhao & Hou, 2008). One study found that tourism-rich jurisdictions with low populations had the greatest per capita sales tax capacity. Suburban jurisdictions had the lowest capacity. All statistical differences between urban,

suburban, tourism-rich, and rural counties disappeared when property taxes were included in the capacity measure (Afonso, 2016). Another study found that both tourists and in-commuters are critical portions of the sales tax base (Afonso & Moulton, 2021). This exporting of tax burdens helps to explain the popularity of sales taxes (Afonso, 2018a; Burge & Piper, 2012; Sjoquist et al., 2007; Zhao, 2005). However, there are outcome disparities. A report prepared for the state of Connecticut estimated that the revenue generated by municipal sales taxes would range between $5–$717 per capita across the state (Sjoquist, 2015).

Despite many of their less positive elements, sales taxes are administratively and politically feasible. In most states, local sales taxes are collected by the state and distributed back to the taxing jurisdictions (Afonso, 2019). Sales taxes are also politically feasible and have been shown to be a preferred method of taxation. For example, in Georgia 94 percent of all referendums on local sales taxes earmarked for education have been approved by voters, demonstrating a preference for sales taxes over property taxes (Brunner & Schwegman, 2017). However, two reasons that are often cited for this popularity are reduced tax salience and increased revenue complexity, both of which can cause taxpayers to underestimate their true tax burden (Brunner et al., 2015; Buchanan, 1967; Cabral & Hoxby, 2012; Wagner, 1976). Therefore, sales taxes are not transparent.

The cost of administration is typically low for local governments because local sales taxes are typically collected by the state. However, there are states where local governments are responsible for the administration of these taxes, which increases the administrative cost of the taxes for local jurisdictions. A tax's compliance costs are also increased when local governments administer the tax or choose the tax base. In fact, the diversity in local rates, bases, and

administration is one reason why remote vendors did not have to collect sales or use taxes before *South Dakota v. Wayfair* (Afonso, 2019).

The literature on local sales taxes has grown tremendously since the turn of the century. There has been analysis on drivers of adoption, vertical and horizontal competition, volatility of revenue portfolios, fungibility of earmarked revenues, and tax competition. A review of all this literature is outside the scope of this chapter.

Local Option Excise Taxes

Excise taxes can be understood as selective sales taxes, and they fall into three primary categories: luxury, sumptuary or sin,[1] and benefit based (Lee et al., 2020). They differ from sales taxes in two primary ways. First, an excise tax has a much narrower base than a sales tax, being imposed on the sale of specific goods or services. Second, there is more variation in administration. Unlike retail sales taxes, excise taxes can be imposed when a good is imported, sold by the manufacturer, sold by the retailer, or used. Excise taxes can also be a flat per unit cost or, like retail sales taxes, be a percentage of the cost of the good or service (though typically there is little discretion in setting the rate). This subsection proceeds with examples of common and emerging excise taxes that highlight this diversity.

Meals Taxes

Eight states have authorized municipalities to levy a local option meals tax, and Rhode Island levies a local meals tax that is uniform and not a LOT (see Table 1).[2] Meals taxes are

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[1] It is important to note that many sin taxes are also Pigouvian taxes. Pigouvian taxes are designed to correct for negative externalities, whereas sin taxes are designed to discourage behaviors and correct for internalities. A classic example of a Pigouvian tax is a carbon tax that corrects for the negative externality of pollution, which creates costs that are not captured by the parties involved in the transaction of fuel. However, tobacco usage and obesity create health-care costs to society, so it is reasonable to think of many sin taxes as Pigouvian taxes as well. Thus, many sin taxes are efficient by correcting for negative externalities.

[2] North Carolina permits local governments to institute a prepared food tax through legislative action by the General Assembly. This is also how local occupancy taxes are levied in North Carolina.

luxury taxes that tax prepared food purchased at a restaurant and any foodstuffs for immediate consumption. One of the advantages of a meals tax is that the burden can be partially exported to nonresidents. In some states, there are restrictions on which jurisdictions can levy meals taxes. For example, in Washington only counties with populations over one million can levy a meals tax. Only King County, where Seattle is located, meets that criterion. In Florida, there is a municipal resort tax available to select cities that allows them to tax meals up to 2 percent. In fact, local governments in Florida have the ability to tax meals served at hotels and motels at a higher rate than meals served elsewhere (Walczak, 2017).

Meals taxes are not efficient because they tax a small portion of the tax base, do not tax substitutions, and are easy to avoid. In most states, unprepared food and groceries go untaxed by both sales and meals taxes. For example, groceries are not subject to sales or meals taxes in Minnesota, but in Minneapolis, taxpayers pay a 7.775 percent sales tax and a 3 percent meals tax, for a total of 10.775 percent, on a restaurant meal. This is likely to distort the decision to eat out or purchase prepared foods. It may also encourage consumers to seek out meals in jurisdictions with lower taxes.

Regarding equity, meals taxes are considered a luxury tax because they tax prepared food and restaurant dining, but it is unclear how progressive they are. As discussed above, sales taxes are typically regressive and taxes on food are especially so. However, meals taxes are likely more progressive than taxes on groceries.

Despite the associated concerns, meals taxes are politically feasible. This may be due to factors including the presence of earmarks, the ability to shift burdens to nonresidents, or the overall burdens’ lack of transparency. As with sales taxes, referendums on meal taxes are largely successful, which demonstrates their popularity. Massachusetts began permitting municipalities

to levy a meals tax in 2007, and by 2009, 65 had adopted one (Zhao, 2011). Also, there is evidence that earmarks increase the likelihood of a successful referendum (Bowman et al., 1992). Tax exportation may also explain this popularity. For example, in North Carolina, meals tax revenues are earmarked for tourism promotion and cultural amenity expenditures, which suggests that they are viewed as a tool to export tax burdens to nonresidents, though the ability of municipalities to shift the burden of meals taxes to nonresidents varies tremendously.

Occupancy Taxes

The occupancy tax is available to municipal governments in 43 states, making it the most common LOT available in the United States. Occupancy taxes are known by numerous names, including *hotel*, *lodging*, *bed*, and *transient room* taxes. Occupancy taxes apply to short-term lodging, like hotels and motels. However, the scope of the tax base has been a contentious topic as Airbnb rentals and online travel companies (such as Priceline) have proliferated while going untaxed (Sonnier & Nichols, 2018). It is unclear how much the inclusion of these new platforms has changed occupancy tax revenues. There are early estimates suggesting that the taxation of Airbnb rentals would generate significant revenue in major urban centers. In 2015, the estimated revenue for taxing Airbnb rentals like hotel rooms was $28.5 million in New York City and $25.9 million in Los Angeles, and Airbnb’s market share has only been growing (Shatford, 2016). Much like the impact of the *Wayfair* ruling on sales taxes, this is an area that should be further explored as laws have caught up with technology.[3]

While fiscal disparities and unequal revenue-raising capacity is a concern for all LOTs, it may be especially worrisome for occupancy taxes where some communities have significantly greater levels of tourism and business travelers. However, interjurisdictional differences are not

[3] Even without Airbnb and online travel companies, noncompliance was a substantial concern (Crotts & McGill, 1995).

the only revenue concern. The overall size of the tax base is smaller for occupancy taxes than for local sales or income taxes, making occupancy taxes a less adequate tax instrument (Wooster, 1987).

Occupancy taxes are more progressive than other local taxes, and their burden is borne by nonresidents, which may help explain their popularity (Sebastian & Kumodzi, 2015). However, occupancy taxes are less popular with the business community because of the concern that they reduce tourism, resulting in fewer stays and less spending while traveling. At the local level, this may result in travelers simply opting to find lodging in a neighboring or peer jurisdiction with lower costs (Lee, 2014).

Typically, the revenue generated by occupancy taxes is earmarked for tourism development, which raises questions regarding tourism's need to be subsidized and how visitor spending and behavior are influenced by occupancy taxes (and other tourism-related local taxes, like the meals tax) (Martinez-Gouhier & Hunker, 2018). Regardless, this link makes occupancy taxes not only luxury taxes but also benefit taxes: the revenue must be used to attract tourism or to provide new and subsidized attractions for tourists.

Take Texas's local hotel occupancy taxes (HOTs). Municipalities may levy HOTs and the revenue must be allocated to tourism-related expenditures, such as convention centers, sports facilities, historical preservation related to tourism, and signage for tourists (Texas Comptroller, n.d.). Some point out convention centers' reliance on occupancy taxes for funding and question whether the economic benefits of those convention centers justify the taxes (Kalnins, 2006; Sanders, 2014). Local subsidies for sports arenas have also been receiving attention. This is an area where more careful analysis of the costs and benefits of convention centers is warranted. However, the revenues are not just used to improve facilities and fund convention centers. In

Texas, cities with over 200,000 residents and under $2 million in HOT revenue must use 50 percent of the revenue for tourism advertising, which presents similar concerns about the benefit of levying an occupancy tax (Martinez-Gouhier & Hunker, 2018).

Tobacco Taxes

Six states allow municipalities to levy tobacco taxes (see Table 1). The structure of tobacco taxes can vary between taxing all tobacco products or a subsample of them. For example, Pennsylvania's tobacco taxes only tax cigarettes, and only Philadelphia levies the local tobacco tax. Pennsylvania's tax is also an example of the flat per-unit cost. In Philadelphia, the city levies a tobacco tax of $2 per pack and the state levies a $2.60 state tobacco tax. In contrast there is no tobacco tax on large cigars (Pennsylvania Department of Revenue, n.d.a, n.d.b).

Like many sumptuary taxes, tobacco taxes are regulatory in nature—trying to change behavior by increasing the cost of consuming the good, which adds to their political feasibility.[4] However, demand for tobacco products is fairly inelastic, which suggests that increasing the cost will not change demand by as much as it would for a normal good, making tobacco taxes fairly efficient. Still, in states like Pennsylvania, where only some products are taxed, tobacco taxes may encourage people to substitute products that are untaxed or taxed at a lower rate (e.g., cigars, e-cigarettes, and chewing tobacco). Thus, taxing all tobacco products would be more efficient and generate more revenue (increasing adequacy).

Tobacco taxes are also regressive. This is especially true for the tobacco taxes that levy a per-unit cost rather than a percentage of the cost. Take the state of New Mexico, which levies a flat per-pack tax on cigarettes and a tax on cigars of 25 percent of the wholesale price, not to exceed $0.50 a cigar. There is a lot of variability in the cost of cigars (much like alcohol). The

[4] They are also Pigouvian taxes.

price averages between $2 and $50 per cigar, with some costing well over that range (Holts Clubhouse, 2021). A flat per-unit tax is, in this case, increasing the regressivity of the tobacco tax.

Interjurisdictional competition is a problem with all local taxes. There is a robust literature on the practice of evading tobacco taxes by going over state lines and using the internet as a tax haven (Law, 1954; Licari & Meier, 1997; Manchester, 1976). These concerns are also present at the local level.

Soda Taxes

The "soda" or sugary beverage tax is an example of another sin tax designed to discourage consumption. Only eight cities in the United States have a soda tax.[5] In all but two of these cities, the tax only applies to sugar sweetened beverages. In the other two cities—Philadelphia and Washington, D.C.—the tax also applies to beverages sweetened with artificial sweeteners (i.e., diet beverages). Some scholars point out that the soda tax can be considered a Pigouvian tax, which corrects for the negative externalities caused by consumption of sugary beverages, including the health care costs of obesity. Furthermore, many note that it can help correct for negative internalities, the negative consequences on consumers that are ignored (Allcott et al., 2019).

There has already been quite a bit of analysis of the soda tax, including how the tax is typically structured. For example, typically a beverage that is 100 percent fruit juice would not be subject to the tax, which leads to inefficiencies since substitutes are omitted. In this example, given that the sugar content of 100 percent juice, sugar sweetened juices, and sodas are comparable, a tax on only sugar sweetened beverages not only causes distortions in behavior

[5] There are also cases in which some states, including California, Arizona, and Michigan, have preempted soda taxes by prohibiting local governments from adopting them.

(i.e., inefficiencies) but also fails to capture the negative externalities associated with drinking untaxed sugary beverages and to discourage their consumption. Furthermore, the taxation of the lower priced sugary beverages and not the higher priced ones exacerbates the equity concerns regarding the regressivity of the soda tax (Kane & Malik, 2019).

Many proponents of the Pigouvian soda tax do not necessarily support local soda taxes but look to states and the federal government to levy them. This is largely because of the concerns over cross border shopping to avoid the soda tax. For example, a 35-bottle pack of Gatorade in Seattle that was priced by Costco at $15.99 was marked up to $26.33 due to the soda tax. Interestingly, Costco was transparent about this pricing and explained the change in price by posting signage that encouraged consumers to consider going to stores in neighboring jurisdictions to avoid it (Pittman, 2018). This is not just anecdotal; there is empirical evidence that tax avoidance is occurring. Bollinger and Sexton (2017) found that approximately half of the reductions in the purchases of sugary beverages in Berkeley, California, are just being substituted with purchases made right outside of Berkeley. This same pattern has been observed in Philadelphia as well (Roberto et al., 2019; Seiler et al., 2019).

Marijuana Taxes

As an increasing number of states legalize medicinal and recreational marijuana, there are an increasing number of local excise taxes levied on it. But like sales taxes, which often exclude necessities, these taxes frequently exclude medicinal marijuana. Marijuana can be taxed as a percentage of the price, on the basis of weight, or on the basis of potency. While states currently levy taxes on flowers, gross receipts, and retail sales of products with THC, the majority of states only allow localities to levy excise taxes on retail sales, and those are often capped, though Colorado also allows localities to levy a cultivator tax (Urban-Brookings Tax Policy Center, 2020).

Like many excise taxes, states often restrict how the revenue generated by local marijuana taxes may be used. Frequently the revenues are earmarked for programs in related areas, such as criminal justice, public health, and public safety. There are also examples of earmarks for unrelated expenditures, such as education. Illinois and Virginia each have an unusually complicated set of earmarks. In Illinois, the revenue generated by marijuana taxes is first used to pay for the administrative costs associated with the legalization of marijuana. The remaining revenues are split between areas including the general fund, criminal justice reforms, and substance abuse programs (*Adult Use Cannabis Summary*, n.d.). Virginia will begin permitting the retail sales of marijuana and cannabis products in 2024 and will begin taxing them at that time. The state reports that revenues will be earmarked for prekindergarten programs for at-risk youth, substance abuse, and the Cannabis Equity Reinvestment Fund, which will support communities that have been disproportionately affected by drug enforcement efforts historically.[6] The earmarks in these two states demonstrate that marijuana taxes are often loosely benefit taxes. Interestingly it also demonstrates the trend of using earmarks to promote social equity efforts.

Much of the evaluation of marijuana taxes echoes tobacco taxes, though they are new enough that it is not yet clear how elastic the demand for legal marijuana is or how the established illegal networks may continue to affect sales in legal markets—especially as marijuana taxes tend to be high. For example, retail cannabis sales in Virginia will be taxed at 21 percent, and local governments will be able to impose an additional 3 percent on top of the state rate (Apfel et al., 2021). Illinois, on the other hand, has a model based on potency. There is a 7 percent excise tax on the gross receipts, a 10 percent tax on less potent products, a 25 percent

[6] Whether the state earmarks apply to the local revenues is unclear.

excise tax on more potent products, a 20 percent excise tax on edibles, and an up to 3 percent tax levied by counties and municipalities.

Given how high the combined state and local taxes are, there are concerns that the taxes are counterproductive to the goal of reducing or eliminating the black market. Of course, the elimination of the black market is not the sole goal. There is also evidence that with lower rates there will be more users, including those who are underage, since it is currently estimated that demand for marijuana is relatively elastic. (See Pacula and Lundberg, 2014, for an overview of the relevant literature). While it perhaps seems inconsistent to think that states are simultaneously legalizing marijuana and discouraging its use, that is the case. Marijuana taxes are sumptuary taxes, and marijuana is ultimately being treated comparably to alcohol and tobacco.

Local marijuana taxes present similar concerns as other LOTs, such as regressivity, rate differentials, cross border shopping, and competition. Unreliable revenue capacity has also been an issue. Many anticipated that marijuana taxes would be windfalls, but for most states they are generating far less revenue than projected and are volatile (Becker, 2019). While many LOTs do not have higher revenue capacity, the difference is that marijuana taxes have been misforecasted consistently. Ultimately, how marijuana taxes satisfy the tax criteria is still unclear and an area where important work needs to be done.

Local Option Income Taxes

In thirteen states, local governments levy local income taxes (see Table 1).[7] In four of those states, the local income tax piggybacks the state tax. In contrast, local governments in eight

[7] Maryland has local income taxes, but they are not "optional" since the local governments do not choose to levy them. Furthermore, Georgia authorizes local income taxes, but none have been levied.

states levy an earnings or payroll tax that is separate from the state tax entirely. Earnings and payroll taxes are typically a percentage of wages and can be levied on the location of employment rather than the residence. In four states, the local income taxes are levied on employers, not employees (Pinho, 2013). Much like the local sales taxes, the nuances of local income taxes by state vary tremendously by state. For example, Ohio's municipalities administer and collect the local income taxes, but school districts can levy their own local income taxes, and the state is responsible for administrating those taxes (Ohio Department of Taxation, n.d.). Most local income taxes are self-administrated (Pinho, 2013). The dependence on local income taxes varies from state to state. For example, in Oregon and Kansas, less than 1 percent of own source revenue is generated from the local income tax, while in Maryland over a quarter of own source revenue is generated by the local income tax (Urban-Brookings Tax Policy Center, 2020).

Local income taxes have a distinct set of concerns associated with them. First, there are concerns regarding the effect they have on employment. It is expected that local income taxes have a negative impact on the numbers of hours worked (Feldstein, 1995). However, one study of local income taxes in Indiana found that taxpayers were unresponsive to small changes in local income tax rates (Yang & Heim, 2017).

A second concern about subnational government income taxes is migration (see, e.g., Afonso, 2015b, 2018b; Agrawal & Hoyt, 2018; Giertz & Tosun, 2012; Musgrave, 1969; Oates, 1968).[8] While there are concerns at the state level, they are amplified at the local level. However, the evidence of local income taxes on migration is conflicting (Grieson, 1980; Inman et al., 1987; Landers, 2008). In fact, Agrawal and Hoyt (2018) examined the impact of state income taxes at the local level and found that there were substantial responses by high-income earners. Nechyba

[8] The empirical literature is divided on the impact of subnational taxation on immigration (e.g., Young & Varner, 2011).

(1997) introduced a model where local planners can collude and introduce local income taxes simultaneously to minimize efficiency losses like migration—though it would likely require state intervention. The model is tested and evidence suggests that when fiscal competition increases, local income tax use declines (Spry, 2005).

Third, there is a concern over double taxation. In many states, income can be taxed by both the jurisdiction of residence and of employment. Without a credit (typically applied to the place of residence), this can result in double taxation for commuting earners.[9] Lastly, the administration of a local income tax is costly if it is decoupled from the state's income tax. For example, in Pennsylvania, home to the oldest local income tax, local governments were responsible for their own administration of the local income tax. Starting in 2012, countywide tax collection agencies began administering the municipal taxes rather than the municipalities. This reduced the number of earned income tax collectors from 560 to 21 (Berkheimer, n.d.).[10] Thus, differences in the cost of administration are not attributable simply to the differences between local taxes and state taxes. How taxes are structured at the local level is also a factor.

Many of the same LOT concerns remain, such as tax competition between jurisdictions and fiscal disparities. Take fiscal disparities, for example. In 2015, the state of Connecticut commissioned a tax study that considered local tax policies and the impacts they would have on various concerns, like revenue generation, interjurisdictional fiscal capacity, and equity. The study estimated that the distribution of per capita revenues from payroll taxes imposed by place of employment ranged from $22 to $872. For the income surtax across municipalities, the

[9] There are many examples of these credits. For example, Michigan has a straightforward process. Residents pay a tax on their income and nonresidents pay a half rate. Then commuters can receive a credit for the taxes paid to the jurisdiction of employment. In contrast, earners in Birmingham, Alabama, must calculate the share of work done in the city to receive the prorated rate.

[10] Act 32 also required employers to withhold taxes and made the system more uniform overall.

estimated range was $31 to $1,874. Furthermore, the municipalities with the highest potential revenues from local income taxes were the municipalities with the strongest fiscal health (Sjoquist, 2015).

Impact of the Pandemic

The global pandemic brought on by COVID-19 in early 2020 was incredibly challenging for all levels of government. Typically, local governments are less vulnerable to economic downturns than higher levels of government because of their reliance on more stable and less elastic revenue sources like property taxes and user fees. However, for many cities the post–Great Recession recovery of property tax revenue has been slow (Chernick et al., 2021). This has led to increased reliance on other taxes, the largest of which are local sales taxes. In fact, many cities entered into the Great Lockdown with dependence on elastic revenue sources at rates not observed previously. Columbus, Ohio, is estimated to receive more than 75 percent of its general fund revenues from elastic revenue sources. Cities like Colorado Springs; Bowling Green, Kentucky; Cleveland, Ohio; and Aurora, Colorado, are estimated to receive more than two-thirds of their general fund revenues from elastic instruments (Pagano & McFarland, 2020). Therefore, even ignoring the unique challenges and impacts brought on by the pandemic, this trend has put municipalities in a more precarious financial position.

Of course, the Great Lockdown was no ordinary recession. Unemployment spiked immediately, nonessential workers began working from home, tourism halted, schools and universities went remote, and businesses shuttered. There was an instantaneous shock to many municipal revenue instruments. Many of the LOTs discussed in this chapter were especially impacted. For example, local option sales taxes immediately fell. In New York the average year-over-year change in local sales tax revenue in May 2020 was a decrease of almost a third of sales

tax collections, and that number does not account for any projected growth, which would have been expected based on the early months of 2020 (Office of the New York State Comptroller, 2020). Figure 1 presents a similar picture, using revenues from North Carolina's local sales taxes, occupancy taxes, and prepared food taxes. It shows that the impact on LOTs during the pandemic came at incredible speed and were devastating. These impacts reflect the trends nationwide.

<Figure 1>

It is not at all surprising that food and beverage and occupancy taxes experienced considerable declines, given that restaurants shuttered and tourism halted for much of the year. Another effect of the pandemic was that nonessential workers began to work remotely, which affected the distribution of local sales taxes (Afonso & Moulton, 2021). Fuel taxes were affected, too. Early estimates suggest that one billion fewer miles were being driven a day in the United States at the start of the pandemic. In fact, Oregon reports collecting $27 million less in gasoline taxes than forecasted for between January and August 2020 (National Governors Association, 2020); for states with local fuel excise taxes, like Florida, this is meaningful.

Furthermore, the distribution of the impacts has been far from uniform. Some municipalities and counties experienced dramatic declines in LOTs, like the sales tax, but others quickly rebounded and experienced growth. Some of this is likely due to people working remotely in more sparsely populated areas, economic nexus laws requiring online vendors collecting local sales (use) taxes for those no longer shopping in brick-and-mortar retailers, and the economic base of different jurisdictions (Afonso, 2019; Afonso & Moulton, 2021; BBC, 2021).

We typically think of the impact of recessions as short-term changes, though they are critical to the current operations of local governments. However, that does not suggest that the effects of the pandemic will be short term. Business travel decreased tremendously, and it might not rebound to earlier levels. Employees that had not previously been able to work remotely were forced to do so, and this may change how businesses operate moving forward and may allow for increased remote work options, which could save money on office space, parking, and other accommodations. These trends may change where people choose to live. If working remotely is suddenly an option, urban cities may be less attractive to workers who could live in much more low-cost areas that are still accessible to urban centers. Early evidence suggests that this urban flight concern is overblown, and the decreased in-migration is expected to be short lived (Gascon, 2021; Handbury, 2020). However, even small shifts in migration could have major impacts on government revenues collected from LOTs, especially since high-income earners are the most mobile (Afonso, 2015b; Rork & Wagner, 2012; Wildasin, 1993).

Remote work introduces other complications as well. Remote work became a problem in Ohio that necessitated immediate policy. Ohio workers may be responsible for paying municipal income taxes in both the city where they reside and the city where they work.[11] Workers who typically commuted to different counties found themselves responsible for paying taxes to the community they were no longer commuting to. The intent behind collecting income taxes based on place of work is to capture tax revenue from those who use municipal services and do not pay for them through traditional mechanisms like the property tax, but this justification does not hold up during a pandemic. However, Ohio state legislators passed House Bill 197 to allow cities to continue collecting municipal income taxes from noncommuting commuters, which led to a

[11] Some jurisdictions in Ohio reduce rates for commuters.

lawsuit challenging the legislation. "Ohio law permits you to be taxed based on where you live and where you actually perform work. But it doesn't allow you to be taxed based on 'Let's pretend'" (Robert Alt, as quoted in Staver, 2020). Thus, if these patterns continue past the pandemic, it is likely that there will be additional policies and lawsuits in this area.

Conclusion

There are numerous reasons a state may permit local governments to levy LOTs. LOTs allow for greater fiscal autonomy; increase fiscal health and sustainability; permit greater revenue diversification, which may lead to more stability; and reduce reliance on property taxes. However, there are many concerns with greater reliance on LOTs. They are typically more regressive and less stable. They increase interjurisdictional tax competition and exacerbate fiscal disparities. In fact, in two recent state level policy reports considering the introduction of additional LOTs in Massachusetts and Connecticut, a great deal of time was spent cautioning state officials on the increased use of LOTs, noting issues like the fiscal disparities they create (Sjoquist, 2015; Zhao, 2011).[12] Zhao noted that large cities and high income, property-rich municipalities would benefit the most from the LOTs being considered by Massachusetts. If these fiscal disparities continued to grow and led to overall high- and low-capacity jurisdictions, there would likely be increased demand for state transfers rather than increased access to local taxes.

Theory suggests that an increase in the price of a good through taxation results in decreased consumption. This is true for taxes on meals, hotels, televisions, and the like.

[12] Afonso (2016) also examines fiscal disparities in terms of combined local sales taxes and property taxes and does so from the lens of tax leakage. Once she controls for factors likely to affect revenue-raising capacity (e.g., income), she finds that tax leakage created by local sales taxes do not have an impact. Zhao and Hou (2008) have similar findings.

Furthermore, at the local level, tax competition between neighboring communities can be expected to accompany that reduced consumption. This could result in numerous responses, depending on the type of local tax, including the migration of workers, people shopping in a neighboring jurisdiction, or people vacationing in different towns.

There is also conflicting evidence on the influence that greater reliance on LOTs will have on revenue stability. The revenue diversification literature largely finds that greater diversification leads to stability, in keeping with modern portfolio theory (e.g., Carroll, 2009; Jordan et al., 2017). However, there is also evidence that shows that most diversification is a result of moving away from a stable property tax toward greater reliance on elastic sales and income taxes, resulting in greater volatility (Afonso, 2013, 2017b; Holcombe & Sobel, 1995; Hou & Seligman, 2007). Further examination of the impact that increased availability and diversity of LOTs have on revenue portfolios will be important to both scholars and practitioners.

This chapter lays out some of the diversity, complex legal structures, and constraints of LOTs. Additional research on how LOT laws impact the adoption, implementation, and expenditures and the impact of LOTs on revenue portfolios and residents is critical to understand modern municipal finance. The wide variation and complicated nature of the jurisdictional eligibility and the discretionary authority of local option sales taxes across states has led to the majority of analyses being done at the single state level.[13] However, it would be valuable to understand how these legal structures affect outcomes. For example, one analysis of local option fuel taxes in Florida found evidence that the rate setting discretion and the ease of adoption (super-majority versus simple-majority) influenced the timing of adoption (Chen & Afonso,

[13] See Afonso (2017a) for a discussion of the literature.

2021). The variety of ways that laws affect management, policy, and outcomes is an area where much more work needs to be done—along the lines of the excellent literature on TELs.

Of course, tax structure may be influenced by goals other than revenue. For example, sin taxes are designed to discourage consumption, Pigouvian taxes are intended to correct for negative externalities, and taxes on marijuana pursue numerous goals, including eliminating the black market and correcting past social harms. Further examination of the effectiveness of LOTs at accomplishing these goals and the trade-offs with other goals is an area where additional work can be done. For example, what is the most important goal of a soda tax? If it is reducing the consumption of sugar, then a tax based on "potency" (sugar content) would be expected to be the most effective. However, if revenue-raising and ease of administration are the main goals, then the current system, which bases the tax on the beverage's volume, is the reasonable choice (Francis et al., 2016). Furthermore, cities like Philadelphia and Washington, D.C., that are also taxing diet beverages demonstrate that revenue-raising may be the primary driver rather than reduction in sugar consumption.[14] How these choices affect revenues, consumption, equity, and tax leakage is important for policy makers to understand.

Lastly, methodological advances and new sources of data present exciting opportunities for future research. For example, there has been a great deal of research on tax leakage and cross border shopping, but with mobility data provided through cell phone usage, a recent paper estimates that there is a 1 to 1.5 percent decline in store visits with a 1 percentage point increase in the local sales tax rate (Miller & Omartian, 2021). Of course, given that the majority of the literature has focused on local sales taxes, expanding the research to other LOTs is also important.

[14] It appears that the Philadelphia tax may have also been a tool in the feud between city elected officials, an infamous labor leader, and the teamsters (Boyer 2019).

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