

and (6) retain the responsibility of each state to its own residents for the economical expenditure of funds, by seeing to it that those residents bear an appropriate share of the burden of such expenditure.

IV. LOCAL PROGRESSIVE TAXATION

Situs Problems

The chief difficulty in adapting progressive taxes to the use of cities, counties, and other local jurisdictions is again the problem of interjurisdictional incomes, but in a more acute degree. While there are only a few areas in which state lines separate the residence and place of work of large numbers of individuals, this occurs very frequently with local boundaries. More serious, there are local jurisdictions which are predominantly residential, industrial, or commercial to a degree that would preclude the collection of an income tax on the basis of residence alone. Fortunately, the situs of earned income is usually fairly easy to establish, and usually earned income is not divided among several jurisdictions. Accordingly, one possible solution to the problem would be to share the tax on earnings, salaries, wages, and the like between place of work and place of residence, while property income would be taxed only at the place of residence. Some difficulties may arise in determining the situs of earnings of transportation workers, traveling employees of various kinds, and officials of interstate companies. Acceptance of a standard, consistent formula of allocation might well be made a prerequisite to the use of state or federal collection machinery.

Wherever situs of income is the occasion for the tax, the tax can well be graduated only slightly, if at all, after provision for personal exemptions; the tax at place of residence would then be the vehicle for such further progression of the tax as seems desirable. This division of the progression is not only of practical advantage, in that it avoids the more serious instances of splitting income among several jurisdictions, but also can well be justified on the grounds that facilities fur-

nished by the community to facilitate the earning of income are little related to the degree of concentration of income, whereas the facilities furnished for consumption may well be of such a character as to make steeper graduation appropriate on a benefit principle. Or one might even justify such a graduation as being based on the privilege of residence in a given community, the value of that privilege being considered to be measured by what a person will pay rather than move elsewhere, with a possibility that the value so measured may be considered to bear a progressive relationship to income.

Exemption of Low Incomes

But in any event, the case for progression of the state and local income taxes above the exemption level is considerably weaker than for the allowance of at least a personal exemption: it is relatively easy for the federal government to modify its rate schedule so that, superimposed upon the typical state and local schedules, the desired general pattern of progression is attained. If it is found that graduation of the rates necessarily involves administrative difficulties and inconsistencies that would prevent or delay the adoption of state and local income taxes, or inhibit their becoming an important source of revenue, it would seem preferable to leave this graduation to the federal tax and let the states and localities restrict themselves to flat-rate income taxes with exemptions. There would still be considerable leeway left to such jurisdictions in setting the rate and exemptions; nevertheless, should any state or locality see fit to persist in the use of a more progressive schedule in spite of the inconsistencies or administrative difficulties, it should preferably be left free to do so without unnecessary obstacles being imposed.

Removal of Property Tax

In any event, the crucial obstacle to the adoption of progressive taxation by localities may not be so much the difficulties of the new tax, but the difficulties of getting rid of the old. While most taxes can be repealed or greatly reduced in the course of a few years with relatively little inequity or dislocation of in-

dustry, the real property tax, which is at present the mainstay of local finance, is an important exception to this rule. Sudden replacement of this tax by an income tax (or even gradual replacement over several years) would produce great increases in the value of real property, and windfall profits would accrue to owners of such property. But to retain the property tax permanently, in its present form, is to abandon any hope of obtaining a genuinely progressive tax structure at the local level.

In addition to the regressive incidence of much of the property tax, this tax has other demerits, among which is the inhibitive effect of the tax on real estate improvement. This tax exerts a strong influence, tending to shift investment from fixed improvements, which are usually fully taxed under the property tax, to movable and personal property which is relatively lightly assessed, and to investment in intangibles, such as research, advertising, government bonds and foreign investments, which are hardly assessed at all under most property taxes. It is not too much to say that this tax may be held responsible, to a considerable extent, for the failure of our housing to keep up with advances in our living standards in other directions.¹¹

Complete elimination of the property tax may be going too far, however: there is much merit to the contention that the part of the property tax assessed on land values, exclusive of improvements, has no such baneful influence on investment or regressive incidence, since it cannot affect the supply of land and hence is shifted to the land owner and capitalized rather than passed on to the tenant. There is accordingly no pressing reason for eliminating this part of the property tax; indeed, its retention would reduce the difficulty in shifting to an income tax and would also produce a small amount of revenue in a way that would tend to reduce the unearned increment derived from future increases in land values. The objective then is to find a method of shifting from the present property tax to a combination of income or spendings tax and a tax on land values only, without undue disturbance to property values.

¹¹ Boulding, *op. cit.*, p. 177.

Sudden removal of the tax on improvements would have the effect of increasing, for the time being, the return on existing improved properties by the amount of the tax. This increased return would stimulate new construction until rents and profits were driven down so as to restore the equilibrium between the rate of return on improvements to real property and that on other forms of investment. However, this construction would take time to complete, and in the interim the owners of existing improved properties would reap a windfall profit. Moreover, a sudden spurt of construction activity resulting from a sudden change in tax is probably undesirable, even if it is restricted to a few localities at a time, as would be the case unless all localities made the change simultaneously. Such rapid expansion, unless carefully controlled, may result in congestion or dislocation of facilities and is likely to produce undesirable booms and subsequent depressions in the local building trades. Even though this expansion and contraction of the construction industry could be met in considerable measure by migration from other communities, it would be preferable to have the change take place somewhat more gradually. To accomplish this, the rate of tax applicable to improvements could be reduced gradually over a period of years rather than all at once. Not only would this tend to spread the period of new construction out to the point where it would be more likely to be orderly, but the rate of reduction could be adjusted to correspond with the reduction in rentals resulting from the new construction, and thus prevent the development of windfall profits such as would accrue to owners of existing improvements if the transition were made suddenly.⁸

Additional improvements resulting from the removal of the tax on improvements may tend to produce an increase in the value of unimproved land; accordingly, it would be entirely ap-

⁸ It is possible that some owners of improved properties might lose slightly through their properties becoming partially obsolete as a result of the change. For example, the removal of the artificial differential introduced by the property tax might make it more profitable to construct more durable concrete or steel buildings where formerly frame construction was used because of lower taxes. Owners of frame buildings may then find their rents reduced by more than the reduction in tax. But this effect will probably be relatively small.

propriate to increase the rate on land values somewhat above the original property tax rate, so as to absorb this unearned increment and keep speculative profits from arising. But this increase in the tax on land values should not be expected to replace any major part of the revenue lost through the elimination of the tax on improvements; there will still be a net reduction in revenue and a need for income or other progressive taxes to make up the lost property tax revenue as well as to replace other regressive local taxes.^b

The major difficulty with the adoption of such a program is convincing property holders and potential builders that the program is actually going to be carried through as scheduled, and at the same time preventing subsequent administrations from restoring the property tax and thus subjecting property owners who built in anticipation of the reduced taxes to unfair reductions in their rate of return. In particular, it will be necessary to have definite assurance that the proposed substitute tax, whether an income tax or a spendings tax, is workable and can actually be made to produce the needed substitute revenue. Actual experience with the new tax seems a prerequisite to committing the local government to any specified schedule of property tax reduction. Accordingly, it will probably be well to impose the income or spendings tax at a low rate for one or two years before the property tax reductions actually begin, and then raise the rates as required.

A general policy of eliminating the general purpose property tax on improvements does not preclude retaining a reduced rate of tax on improvements as a reflection of those municipal and local expenses which are directly related to the value of the improvements, such as fire protection, inspections of various kinds, and possibly a share of outlays for street maintenance, transportation facilities, and police protection. Such directly related public expenses are a part of the social cost of the improvements and should properly be charged against the user of

^b It may be noted that Pittsburgh and Scranton have had considerable success, under a special enabling act applicable to second class cities in Pennsylvania, in reducing the rates on improvements to 50% of those on land values: a further reduction in rates on improvements is contemplated. [*American City, May, 1945, p. 117.*]

the improvements in order to secure the most economical allocation of resources.

But even with these directly related items, allowance must be made for the fact that fire protection expenses, for example, do not and should not necessarily vary in proportion to the value of the property protected; the marginal outlays that are necessary to maintain a given standard of protection, in the face of further property improvements, may be greater or less than the average outlay per dollar of the value of property improvements, and it is this marginal cost, be it more or less than the average, that is to be charged against the property in the form of a tax. Accordingly, the revenues from such taxes may be more or less than the actual total outlays for the services considered. Indeed, the value of the property may not be the most suitable base to which to assess these costs. Other factors, such as cubic volume, height, frontage, number of occupants, may be more relevant than whether the finish is steel and plaster or bronze and marble.

But whatever is the base on which such charges are assessed, the amount thus collected on improvements would be small compared to existing levels of property taxes. The cost of facilities such as schools, which depend on the size of the population and not on the value of the property in which it works or is housed, should not be defrayed at all by taxes on improvements. And the height of the tax on land should be governed by equity considerations of preventing landowners from realizing unearned increments on the one hand or from being unduly penalized on the other; the rate should therefore be determined entirely independently of the revenue needs of the community. Any variations in revenue needs should be met by variations in the income tax rates.

Spending Tax as a State or Local Tax

With a spending tax, the interjurisdictional problems take on a different aspect. There is, of course, no question of any tax payment to jurisdictions covering the source of the income spent: the source of the funds is irrelevant under a spending tax. Nor is it possible to consider, except in the most imme-

diate sense, the source of the goods and services included in consumption. For practical purposes the spendings tax must be considered as limited to a tax on residents only. A partial exception might be made in the case of extended visits to other jurisdictions, such as for vacations or change of residence during the year, or where establishments are maintained in more than one jurisdiction, or in the case of commuters living in a different jurisdiction from that in which they work. But by and large the spendings tax would have to be limited to a single levy imposed at the place of residence.

The main difficulty with the spendings tax, as the chief local progressive tax, is that it would leave in an unsatisfactory state the financing of those governmental outlays that are connected with the production of income rather than the spending of it. Some of these outlays, to be sure, are roughly proportional to some measure of physical production, such as the value of property employed, and therefore can be assessed directly as a tax on the appropriate base (for example, on property improvements in the case of fire protection) in such a way as to enter into the marginal cost of production, and so cause the producers' marginal cost to reflect the marginal social cost of production, and ultimately cause the market price to reflect this social cost, if competition is effective. But there are likely to be considerable intra-marginal residues (sometimes called negative rent) which must be met by taxation if this equivalence between market price and social cost is to be made possible, and in addition costs which cannot be adequately transmitted by such *in rem* taxes. Accordingly, as long as the maintenance of such services to production are the responsibility of state and local jurisdictions, there will be a logical case for something approaching an income tax on incomes arising within the jurisdiction, and in the smaller and more specialized jurisdiction some such tax will be a necessity.

One might accordingly consider for the progressive part of a local tax system a combination comprising a flat-rate tax on unearned income collected at the place of origin, a progressive tax on earned income likewise payable to the place of origin of the income, and a progressive spendings tax collected at the

place of residence. The necessity for such a complicated arrangement, if a spendings tax is to be used at all, is indeed a powerful argument against the use of a spendings tax by local jurisdictions. Possibly the need for collecting any large tax on the basis of origin of income could be avoided by an extensive geographical rearrangement of jurisdictions so as to eliminate largely the division of work and residence between separate jurisdictions. But such a rearrangement appears even more utopian than these tax proposals, and, in any case, would not offer a complete solution. The spendings tax seems better adapted to the federal level of taxation than to state and local levels, at least under present conditions.