



Local Option Taxes: Promises and Limitations

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Arguments for Local Option Taxes

- Meet growing need for own-source revenue
 - State aid cuts
 - Property tax limitations
- Reduce reliance on the property tax
- Increase revenue diversity
- Collect revenue from tourists and commuters



Fiscal Impact of Local Option Taxes

- To what extent would local option taxes boost the revenue-raising capacity of municipalities?
- What type of communities would benefit most from local option taxes?
- Would adding local option taxes alleviate fiscal disparities across communities?



Studies on Local Option Taxes in New England

- Zhao (2010), "The Fiscal Impact of Potential Local-option Taxes in Massachusetts"
- Sjoquist (2015), "Diversifying Municipal Revenue in Connecticut"
- Research approach: apply a hypothetical tax rate (often 1%) to tax bases across all municipalities
- Findings are similar and are likely generalizable to other New England states



Common Types of Local Option Taxes

- Local sales taxes

- Tax base: general sales vs. selective sales (e.g., meals)
- 34 states have local general sales taxes

- Local income taxes

- Tax base: income of residents vs. payroll by place of work
- 14 states have local income/payroll taxes



Local option taxes have revenue potential, but high dispersion.

**Per Capita Local Option Taxes across MA Municipalities
(in 2008 dollars)**

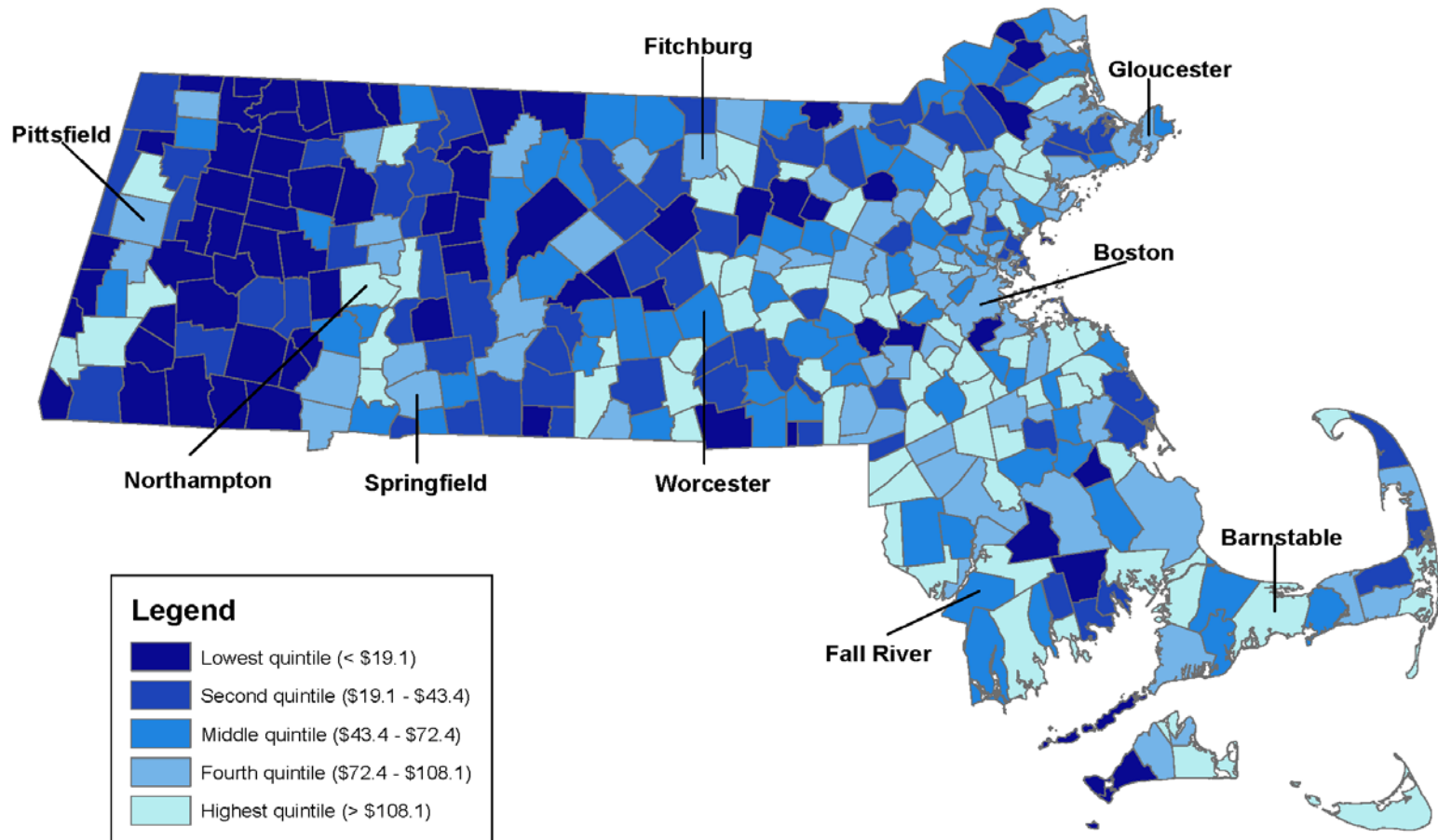
	Average	80% / 20%
Local Meals Taxes	15	2.5
Local Sales Taxes	93	2.2
Local Payroll Taxes	283	3.8
Local Income Taxes	335	2.0

Notes: 1. The tax rate for local sales, payroll, and income taxes is assumed to be 1%. The tax rate for local meals taxes is assumed to be 0.75%.

2. 80% / 20% = the ratio of the 80th percentile to the 20th percentile.

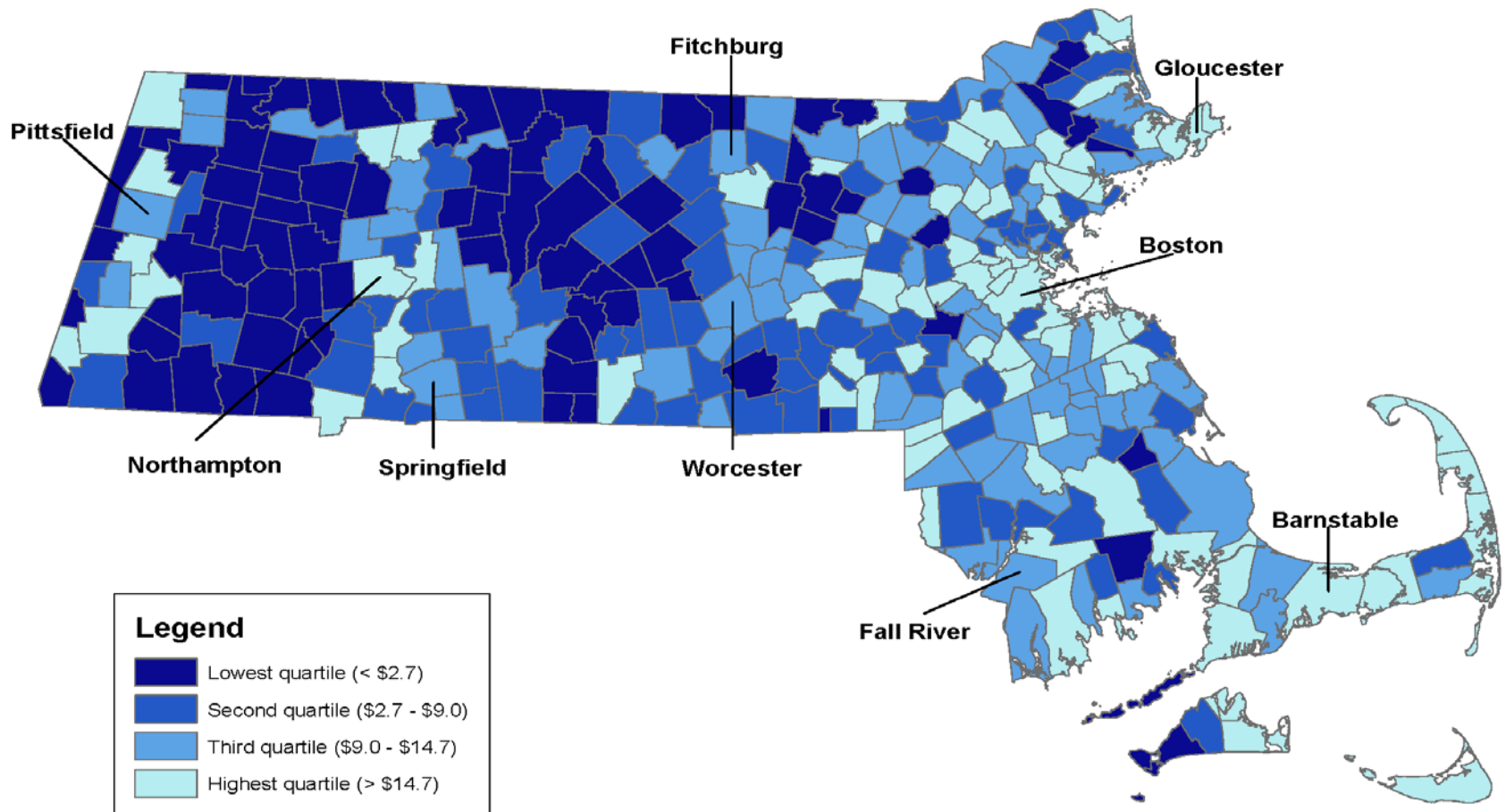
Local sales taxes tend to be higher in eastern MA and lower in western MA

Local Sales Tax Capacity of Massachusetts Cities and Towns
(per capita, in 2008 dollars)



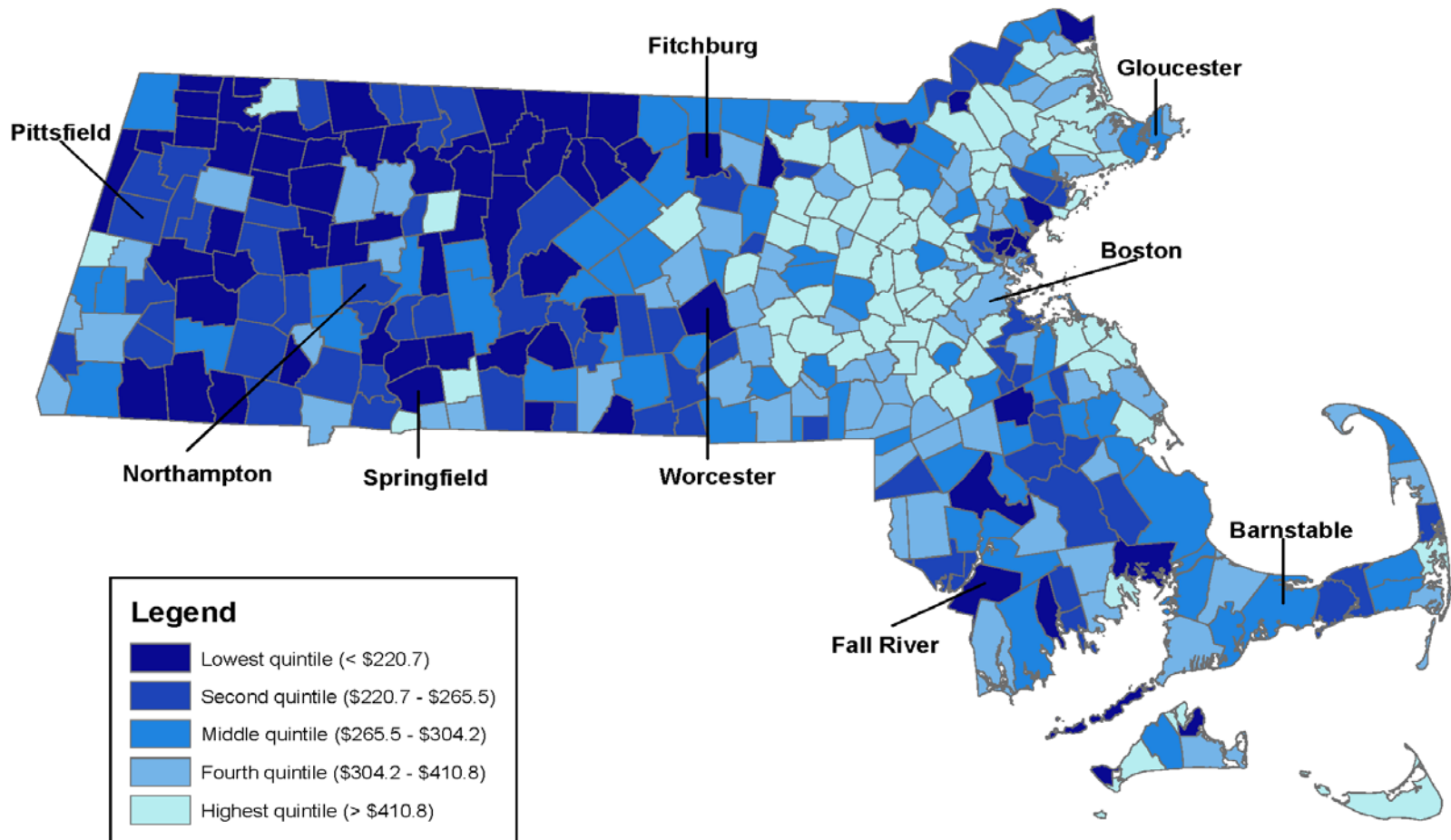
Local meals taxes also tend to be higher in eastern MA and lower in western MA

Figure 3. Local Meals Tax Capacity of Massachusetts Cities and Towns
(per capita, in 2008 dollars)



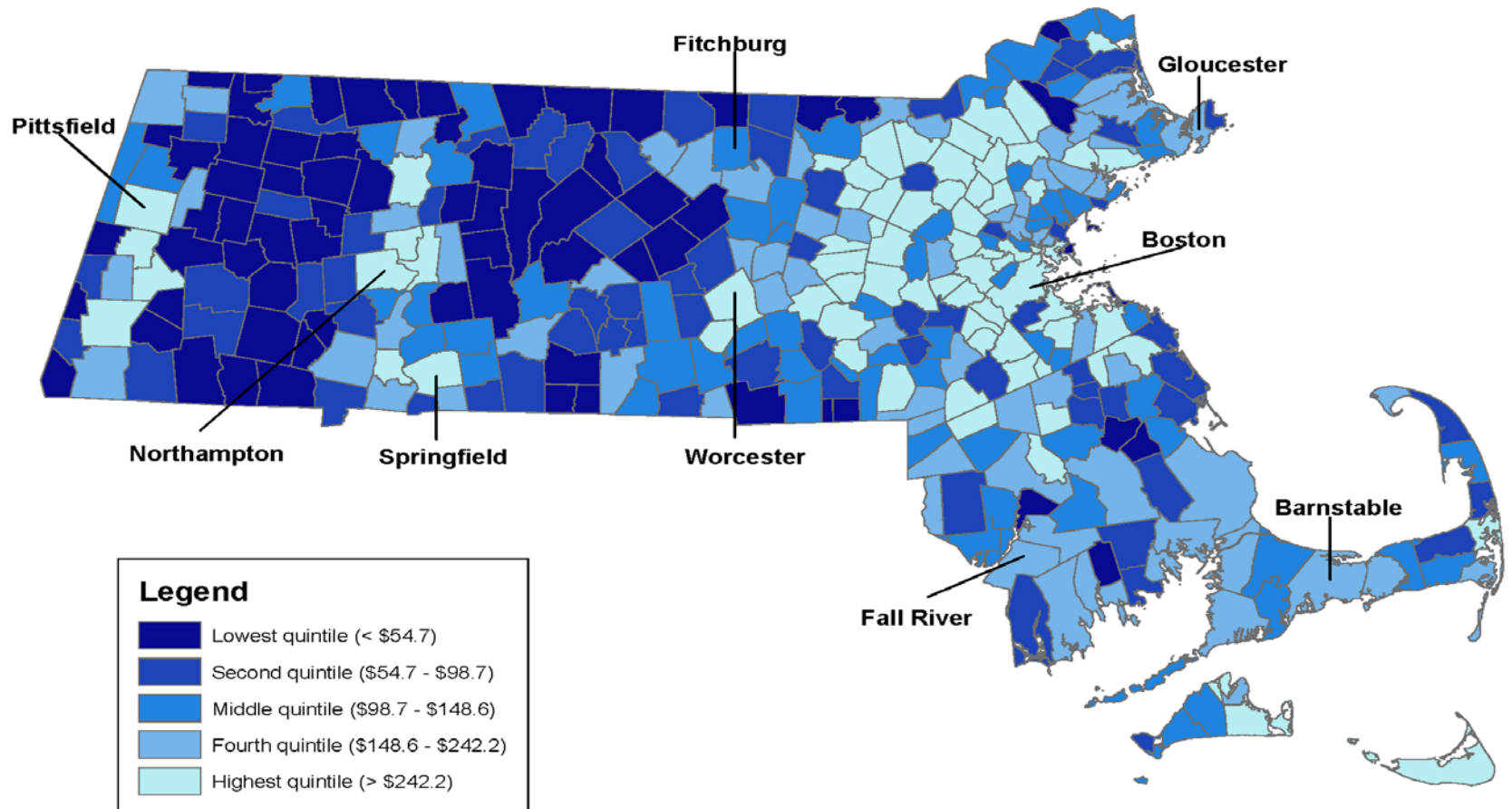
Boston suburbs tend to have the highest local income taxes

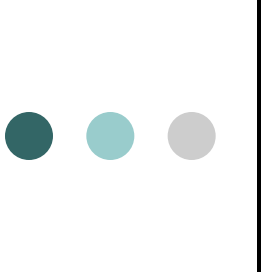
Local Income Tax Capacity of Massachusetts Cities and Towns
(per capita, in 2008 dollars)



Local payroll taxes tend to be heavily concentrated in and around the three largest cities

Local Payroll Tax Capacity of Massachusetts Cities and Towns (per capita, in 2008 dollars)





Largest cities likely benefit more from local sales, meals, and payroll taxes

Table 3. Distribution of Local-Option Tax Capacity by Population Quintile (per capita, in 2008 dollars)

	Lowest Population Quintile	Second-Lowest Population Quintile	Middle Population Quintile	Fourth-Highest Population Quintile	Highest Population Quintile	Correlation with Population Size
Local Sales Tax Capacity	25	85	84	94	97	-0.07
Local Meals Tax Capacity	3	13	12	13	16	0.51 ***
Local Income Tax Capacity	244	426	397	392	299	-0.05
Local Payroll Tax Capacity	57	167	159	234	336	0.64 ***

Note: Figures are weighted by population.

* Statistically significant at 10%

** Statistically significant at 5%

*** Statistically significant at 1%



Lowest-income municipalities likely benefit the least from local option taxes

Table 4. Distribution of Local-Option Tax Capacity by Income Quintile (per capita, in 2008 dollars)

	Lowest Income Quintile	Second-Lowest Income Quintile	Middle Income Quintile	Fourth-Highest Income Quintile	Highest Income Quintile	Correlation with Income
Local Sales Tax Capacity	75	80	116	124	84	0.05
Local Meals Tax Capacity	10	19	17	17	12	0.01
Local Income Tax Capacity	177	287	280	354	687	0.91 ***
Local Payroll Tax Capacity	173	379	246	338	302	0.16 ***

Note: Figures are weighted by population. Income quintiles are based on the 2000 Census.

* Statistically significant at 10%

** Statistically significant at 5%

*** Statistically significant at 1%



Property-poor municipalities likely gain less from local option taxes

Table 5. Distribution of Local-Option Tax Capacity by EQV Quintile (per capita, in 2008 dollars)

	Lowest EQV Quintile	Second-Lowest EQV Quintile	Middle EQV Quintile	Fourth-Highest EQV Quintile	Highest EQV Quintile	Correlation with EQV
Local Sales Tax Capacity	71	79	98	121	92	0.13 **
Local Meals Tax Capacity	10	11	14	20	19	0.37 ***
Local Income Tax Capacity	184	260	314	380	673	0.39 ***
Local Payroll Tax Capacity	163	152	269	478	309	0.11 **

Implications: Local option taxes are unlikely to alleviate fiscal disparities.

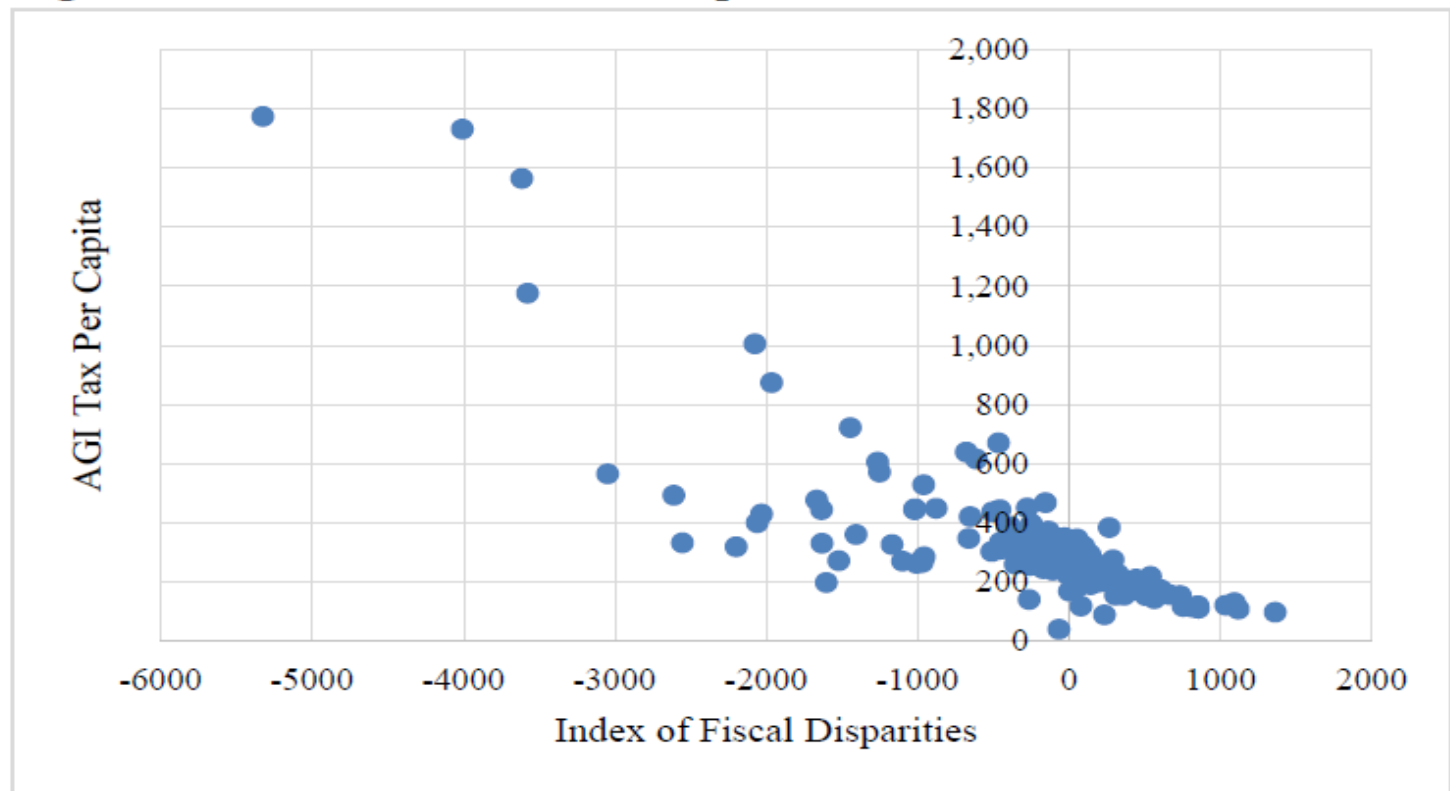


CT Local Option Tax Estimates

- Per capita local sales taxes at a 1% rate: \$5 – \$717
- Per capita local income taxes at a 0.75% rate: \$40 – \$1,773
- Per capita local payroll taxes at a 1% rate: \$22 – \$872

Local income taxes are unlikely to reduce fiscal disparities

Figure 10. AGI Tax and Fiscal Disparities



Source of index of fiscal disparities: Zhao and Weiner (2015)



Other Concerns

- May lead to larger expenditures beyond the citizen's desire
- Increase revenue volatility
- Local tax competition
- Administrative costs



Other Concerns

- Cross-border shopping
- Sales taxes are more regressive than property taxes
- Negative effect of income tax on hours worked
- Migration response to income tax



Local Option Tax Design Issues

- Define the tax base
- Specify the allowable tax rate
- Determine whether the tax is optional or mandated
- Determine whether the tax revenue is restricted for specific purposes



Local Option Tax Design Issues

- Determine whether local officials or voters decide to adopt
- Determine whether the state or each town administers the tax
- Specify the share of the revenue collected in a town to be allocated to that town



Conclusion

- Local option taxes could generate considerable additional revenues.
- They are not evenly distributed across population, income, property wealth, or geographic location.
- They are not likely to reduce fiscal disparities.
- Policymakers may also need to consider other economic and design issues related to local option taxes.