

**PROJECT NOTE No. 48**

# **Retail Sales and Individual Income Taxes in State Tax Structures**

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**January 1962**

**TAX FOUNDATION, INC.**  
50 Rockefeller Plaza, New York 20, New York

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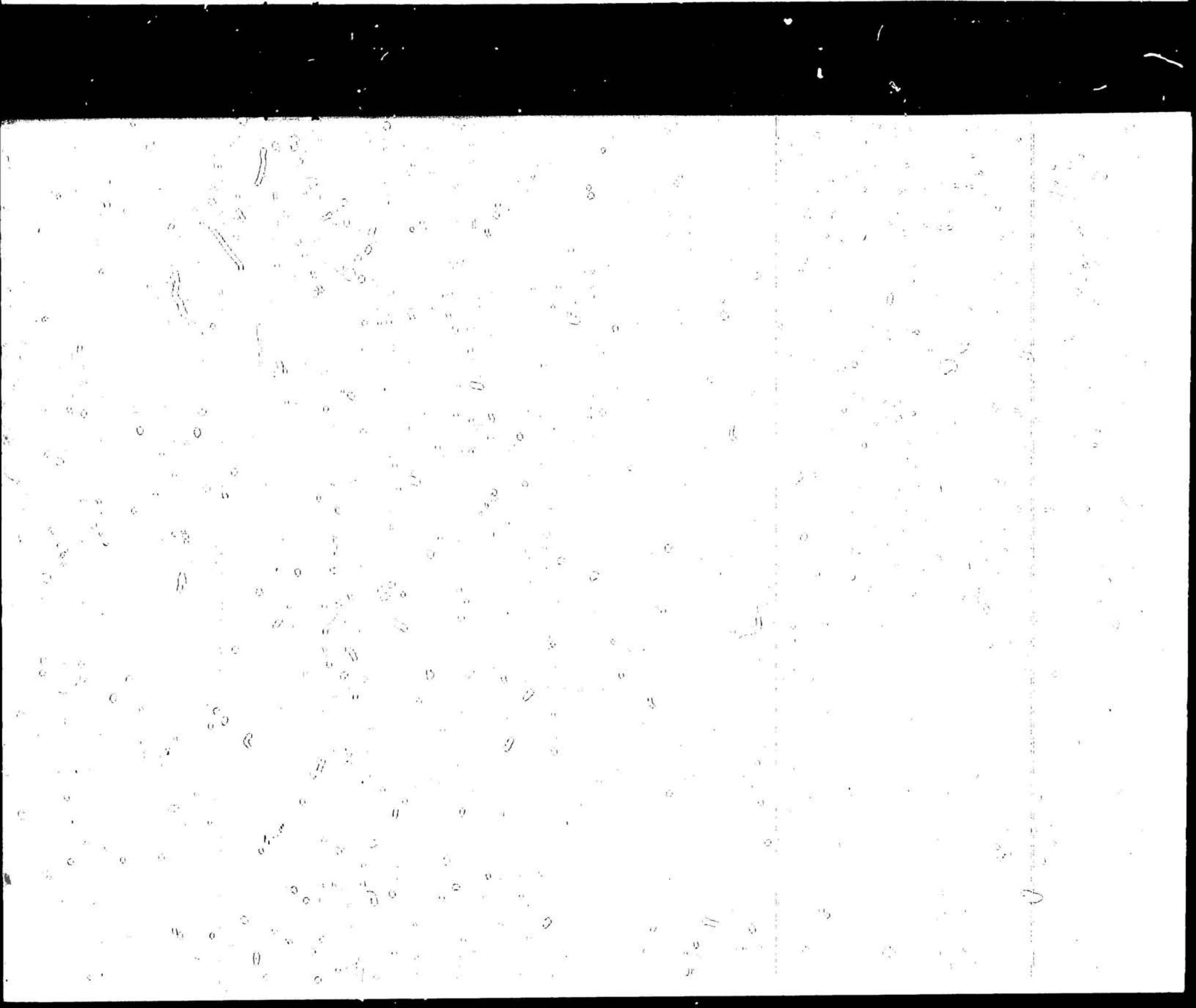
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## FOREWORD

The startling growth of state government expenditures from \$7.1 billion in 1946 to \$31.6 billion in 1960 indicates the heavy pressures to which state tax structures have been subject in the post-World War II years. It may be that the degree of pressure will be somewhat less in the future. Nevertheless, most states still face large needs and demands for increased expenditures. They must decide to what extent increased state government services can be provided, and if so how these increases are to be financed. Among the alternatives are greater utilization of existing taxes or adoption of new taxes.

The purpose of this study is to examine the present and prospective role of the retail sales tax and the individual income tax in state tax structures. The study analyzes the characteristics of these taxes, the extent of their utilization, factors affecting their further utilization, and their advantages and disadvantages as compared with each other and with other forms of taxation. The study does not examine in detail the question of the level and extent of services provided by state governments, but decisions on the expansion of existing programs and adoption of new programs will obviously affect the seriousness of the tax problem.

This study was carried out under the direction of Professor C. Lowell Harriss of Columbia University with the participation of the Research Staff of the Tax Foundation under the supervision of George A. Bishop and Phoebe C. Main.

The study was made possible by a grant from Johnson & Johnson, New Brunswick, N. J. However, Johnson & Johnson had no part in the analysis or the formulation of conclusions presented in this report, and is not to be understood, by virtue of its grant, as approving any statement or view expressed or implied herein.

An earlier version of this study was reviewed by a number of experienced tax administrators, professors of public finance, and corporate tax executives. Their suggestions have been of great value even when, for one reason or another, they have not been incorporated in the present version.

Tax Foundation, Inc., a non-profit organization, is engaged in research and citizen education on government spending and taxation. Its purpose is to aid in the development of more efficient government at least cost to the taxpayer. It also serves as a national information agency for organized taxpayer research groups throughout the country.

TAX FOUNDATION, INC.

January, 1962

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# Retail Sales and Individual Income Taxes in State Tax Structures

## I. INTRODUCTION

Rising expenditures have put increasingly heavy pressures on state treasuries. American taxpayers have obviously responded. *Per capita* state taxes, after allowing for changes in the purchasing power of the dollar, are now about one and two-thirds those at the end of World War II. Yet no end of strain on state finances is in sight.

Some states may find that existing revenue systems can meet their "needs" as economic growth expands tax bases. In other states, however, citizens must match the benefits of greater spending against the disadvantages of adding new revenue sources, of increasing the weight of existing taxes, or of both. Every state also has the opportunity of improving its established revenue system. The higher the total tax bill, the greater the reason for re-examining both the broad outlines of the existing structure and the details of particular taxes.

The choices are difficult. Nothing will make them easy. Facts and analysis, however, will help in making them wise. This study provides facts and analysis about two of the most important existing or potential sources of state revenue—the tax on retail sales and the tax on individual income.

A summary of trends in state finances since 1902 (Chapter II) shows how state governments have expanded their own spending activities and have undertaken heavy responsibilities for financing local services.

New revenue sources, big ones, have been required—and found.

What criteria or principles ought to guide the development of a state revenue structure? Chapter III examines four groups of considerations—revenue; fairness and other factors bearing upon the distribution of tax burdens; the effects of the state's tax system on the efficiency with which the economy operates; and the problems of administration and taxpayer compliance.

The discussion of the two taxes—the sales tax and the tax on individual income—describe the general structure of each, and the major features and problems, including those of administration and compliance. Because of the importance attached to questions of "fairness," and also to the effects of the tax on economic growth, each topic receives explicit attention.

In making choices about expenditures and taxes, the public must do so within limits set by existing realities. Each state's position is somewhat unique, but important considerations which have general applicability are discussed in Chapter VI.

The concluding chapter summarizes the main considerations affecting choice between a tax on retail sales and one on individual income. The section balancing the arguments attempts to help the reader make an informed judgment.

## II. LONG-TERM CHANGES IN STATE TAX STRUCTURES

### From 1902 to 1930

State taxes grew more than ninefold in dollars, and by almost two and a half times as much as gross national product (GNP), in the first three decades of this century. State taxes were only one-seventh of the total of Federal-state-local taxes in 1902; by 1932 they were almost one-fourth. The expansion in the absolute and the relative importance of state taxes was the result of expansion in state spending, which grew even more than state taxation. Two types of spending accounted for most of the increase—highways and education. States themselves undertook more and more responsibility for building and maintaining major highways. For education, however, states, though increasing their outlays for state-operated colleges and universities, made most of their efforts in the form of grants to localities.

Tax changes in this period fall into three broad groups. (1) The relative importance of the property tax as a source of state revenue declined. (2) Motor vehicle license and motor fuel revenues grew tremendously, especially after World War I. However, spending on facilities for motorists increased more rapidly. (3) Taxes on corporation and personal income were adopted by about one out of four states after Wisconsin's successful entry into the field of income taxation, beginning in 1911. Income tax revenue, however, was only a small fraction of that from the taxes on motor fuel and licenses.

Among the many less important changes in revenue systems was the general adoption of state inheritance or estate taxes. A Federal credit in effect put compelling pressure on states to enact such levies.

### The 1930's

The depression of the 1930's was unusually deep and exceptionally long. Its effects on state (and local) finances were profound. Revenues dropped sharply. The ability to borrow also fell markedly and in some cases disappeared. States and localities reduced not only capital outlays but also regular services; they cut personnel and pay rates. Yet, especially in view of rising demands for welfare assistance, expenditures could not be cut as much as revenues fell.

Receipts from taxes on individual and business income and from inheritance taxes fell sharply. By contrast, yields from motor fuel and vehicle taxes and the few taxes on business gross receipts held up fairly well. Collections from the property tax dropped, adding somewhat to the financial difficulties of the states but creating truly serious trouble for cities, towns, counties, and school districts, all of which were almost entirely dependent upon this revenue source. Property tax delinquency rose to an average of 20 per cent in 1933; it ranged from

6 per cent in Massachusetts to 40 per cent in Michigan. Localities turned to states for financial help. Owners of property also sought relief from state legislatures.

Although state responses varied widely in detail, three general changes appeared, and appeared very quickly, throughout most of the country. (1) States undertook to pay for a bigger portion of the total of state-local spending. (2) They reduced their own use of the property tax. (3) They used other taxes more heavily, and, most strikingly, added new ones.

By 1937 all but 13 states had adopted (a) one or both of two taxes with broad bases and good revenue potential, or (b) a tax on corporation income. The exceptions included states which had not drastically limited the maximum rates to be imposed on property and states in which the use of gasoline tax revenues for general purposes was not prevented by earmarking.

The most striking change was the introduction of retail sales taxes. Powerful pressure to maintain spending, especially on schools, overcame opposition to this unfamiliar and widely criticized type of taxation.

Although West Virginia had led the way in 1921 and Georgia had followed in 1929, it was the depression which inspired the first widespread use of retail sales taxes. By the close of the 1937 legislative sessions, a total of 31 states enacted sales taxes (Table 7). A dozen states adopted the tax in 1933 and ten did so in 1935. Many were "temporary," but during the decade only ten states repealed the sales tax or let it expire.

Twenty states adopted taxes on personal income in the period from 1929 to 1937. The crest was reached in 1933, with six enactments. Only two states allowed their personal income taxes to lapse.

Levies measured by corporation income were newly imposed by 20 states between 1929 and 1937, with the peak of adoptions also occurring in 1933.

At the end of the decade, then, the states, with just a few exceptions had given up significant use of one broad-base tax, that on property. All but six were placing heavy reliance upon other broad-base taxes—levies on retail sales and the income of individuals—or on corporation income taxes.

Expenditure pressures were by no means satisfied by these revenue changes. States took advantage of the repeal of prohibition and began to tax alcoholic beverages or to engage in liquor retailing at substantial profit. Taxes on tobacco products also appeared.

In 1940, none of the taxes yet mentioned was the largest source of state tax revenue. That place was oc-

cupied by the payroll tax adopted under Federal pressure for financing unemployment insurance benefits.

Grants from the Federal government varied from year to year, but by 1940 were at a level three times as high as in 1932.

Meanwhile, in a number of states the general property tax was reorganized. Some states provided for the exemption of all intangible, and in a few cases tangible, personal property. Other states moved toward the classified property tax by assessing or taxing tangible personal property at lower rates than real property. To compensate the localities for the resulting loss of revenue, the states offered to them shares of the proceeds of certain of the newly imposed taxes.

#### World War II

During the period from 1940 to 1946, state expenditures increased slowly. Capital outlays actually dropped, in part because of shortages of labor and materials. Spending on other state functions increased as the price level rose, but only a little.

The reenactment of the Louisiana retail sales and use tax in 1942 (after a two year lapse), was the only broad-based tax adopted by the states in the decade from 1937 through 1946. State revenues rose more than expenditures during the period, and most states accumulated surpluses. Rates of eleven broad-base taxes were reduced by the states during the period (Table 5).

#### From 1946 to 1961

When the war ended, pent-up demands for spending were released. Needs for capital outlays had accumulated. Inflation had raised costs. Population had grown. Reserves had accumulated. The country was more than ever urban—and suburban—and such areas demand more governmental services than rural areas. Auto usage began a rise which was to lead to vast increases in street and highway spending. Conditions in the capital market were favorable to borrowing. The tremendous growth in school-age population forced large expansion in spending on education.

Total state expenditures doubled between 1946 and 1950 and doubled again in the 1950's (Table 3). Some

Table 1

### FEDERAL, STATE AND LOCAL TAX REVENUE IN RELATION TO GROSS NATIONAL PRODUCT

Selected Fiscal Years 1902 – 1960

Fiscal Year	Gross National Product <sup>a</sup> (Billions)	Tax Revenue						As a Percentage of Gross National Product				
		Amount <sup>b</sup> (Billions)			Total	Federal	State	Local	Total	Federal	State	Local
1902	(c)	\$ 1.4	\$ 0.5	\$ 0.2	\$ 0.7	—	—	—	—	—	—	—
1922	\$ 70.3	7.4	3.4	0.9	3.1	10.5	4.8	1.3	4.4	—	—	—
1932	76.3	8.0	1.8	1.9	4.3	10.5	2.4	2.5	5.6	—	—	—
1940	91.1	14.2	5.6	4.2	4.5	15.6	6.1	4.6	4.9	—	—	—
1946	213.6	49.0	37.9	6.0	5.2	23.0	17.7	2.8	2.4	—	—	—
1950	258.1	54.8	37.9	9.0	8.0	21.2	14.7	3.5	3.1	—	—	—
1955	363.1	87.9	63.3	12.7	11.9	24.2	17.4	3.5	3.3	—	—	—
1960	482.8	127.0	88.4	20.2	18.4	26.3	18.3	4.2	3.8	—	—	—

a. For calendar year ending six months before end of fiscal year; i.e., fiscal year 1960 collections applied to calendar year 1959 gross national product.

b. Includes social insurance taxes.

c. Not available.

Source: U. S. Department of Commerce.

Table 2  
STATE TAX COLLECTIONS FROM SELECTED SOURCES  
Selected Fiscal Years 1902 - 1960

Fiscal Year	Total Taxes	General Sales or Gross Receipts	Individual Income	Corporation Income	Highway User <sup>a</sup>	Property	Unemployment Compensation	Other <sup>b</sup>
A. Amount (Millions)								
1902	\$ 156	-	-	-	-	\$ 82	(c)	\$ 74
1922	947	-	\$ 43	\$ 58	\$ 165	348	(c)	333
1932	1,890	\$ 7	74	79	862	328	(c)	540
1940	4,157	499	206	155	1,226	260	\$ 844	967
1946	5,971	899	389	442	1,325	249	1,034	1,633
1950	8,958	1,670	724	586	2,299	307	1,028	2,344
1955	12,735	2,637	1,094	737	3,444	412	1,138	3,273
1960	20,352	4,302	2,209	1,180	4,803	607	2,316	4,935
B. Percentage Distribution								
1902	100	-	-	-	-	52.6	(c)	47.4
1922	100	-	4.5	6.1	17.4	36.7	(c)	35.2
1932	100	0.4	3.9	4.2	45.6	17.4	(c)	28.6
1940	100	12.0	5.0	3.7	29.5	6.3	20.3	23.3
1946	100	15.1	6.5	7.4	22.2	4.2	17.3	27.3
1950	100	18.6	8.1	6.5	25.7	3.4	11.5	26.2
1955	100	20.7	8.6	5.8	27.0	3.2	8.9	25.7
1960	100	21.1	10.9	5.8	23.6	3.0	11.4	24.2

a. Includes motor fuel tax and motor vehicle and operators licenses.

b. Includes death and gift, tobacco, alcoholic beverages, severance, life insurance premium, public utility, security transfer, pari-mutuel and other.

c. Not available.

Source: U. S. Department of Commerce.

of this increase was for traditional state functions. But other forces were at work. Growth of highway spending was tied closely to the Federal highway program. Even more powerful was the increasing pressure from local governments for financial aid. Although property tax revenues rose rapidly, they failed to satisfy demands, and localities turned to states with success. State payments to local governments doubled between 1946 and 1950 and doubled again between 1950 and 1960 (Table 3). A few states also acted (eight in 1947) to permit local governments to impose new taxes. New York authorized localities to impose certain specified levies; Pennsylvania, on the other hand, granted local governments permission to enact any tax not being imposed by the state. The results included local taxes on wages and salaries, in some cases,

on retail sales in others, and here and there on miscellaneous items.

The increase in state grants contributed to a change in the relative size of state and local spending. Whereas in 1902 the states were spending only 17 per cent of the total, their share was 53 per cent in 1959.<sup>1</sup>

Where did the states get the money? The growth of the economy automatically increased yields of many existing taxes. Deliberate action has also been required, and there has been much. Each set of legislative sessions brings dozens of major changes and hundreds or thousands of

<sup>1</sup> State grants to localities are counted as state expenditures in these figures.

minor amendments to state tax systems. Although over the years there have been broad studies of state systems as a whole, the changes actually made have for the most part been piecemeal. The results include considerable variation (Table 4).

The major emphasis, without question, has been on consumption taxes. Tobacco and motor fuel taxes among the selective excises have been made to produce ever-increasing revenues. Alcoholic beverage tax rates have also been raised. More important, however, has been the

Table 3

**EXPENDITURES, REVENUE AND DEBT OF STATE AND LOCAL GOVERNMENTS**  
**Selected Fiscal Years 1902 - 1960<sup>a</sup>**  
**(Millions)**

Fiscal Year	Expenditures			Revenue			
	Total	Direct <sup>c</sup>	Inter-governmental <sup>d</sup>	Total	From Own Sources	Inter-governmental <sup>e</sup>	Gross Debt <sup>b</sup>
<b>A. State Governments</b>							
1902	\$ 188	\$ 136	\$ 52	\$ 192	\$ 183	\$ 9	\$ 230
1922	1,397	1,085	312	1,360	1,234	126	1,131
1932	2,829	2,028	801	2,541	2,274	267	2,832
1940	5,209	3,555	1,654	5,737	5,012	725	3,590
1946	7,066	4,974	2,092	8,576	7,712	865	2,353
1950	15,082	10,864	4,217	13,903	11,480	2,423	5,285
1955	20,357	14,371	5,987	19,667	16,678	2,988	11,198
1960	31,596	22,309	9,283	32,838	26,093	6,745	18,543
<b>B. Local Governments</b>							
1902	\$ 965	\$ 959	\$ 6	\$ 914	\$ 858	\$ 56	\$ 1,877
1922	4,594	4,567	27	4,148	3,827	321	8,978
1932	6,420	6,375	45	6,192	5,381	811	16,373
1940	7,743	7,685	58	7,724	5,792	1,932	16,693
1946	9,156	9,093	63	9,561	7,416	2,145	13,564
1950	17,189	17,041	148	16,101	11,673	4,428	18,830
1955	26,230	26,004	226	24,166	17,811	6,355	33,069
1960	39,280	39,071	209	37,527	27,576	9,951	51,213

a. 1960 data include Alaska and Hawaii.

b. Short- and long-term debt outstanding at end of fiscal year.

c. Direct expenditures are amounts as finally disbursed by units of government for their own functions regardless of source of receipts. Include expenditures for utility, liquor stores, and insurance trust; exclude payments for debt retirement.

d. Intergovernmental expenditures: state, principally fiscal aids and shared taxes to local government; local, principally payments to state government for shares of programs administered by the state, services performed by the state and repayment of advances.

e. Intergovernmental revenue: state, principally Federal aid; local, principally fiscal aids and shared taxes from the state.

Source: U. S. Department of Commerce.

Table 4

## PERCENTAGE DISTRIBUTION OF STATE TAX COLLECTIONS BY MAJOR SOURCE AND STATE

Excludes Unemployment Compensation Tax Collections

Fiscal Year 1968

State	Total	Personal Income	Corporate Income	General Sales or Gross Receipts	Higher User	Tobacco and Alcohol	Property	Other
Alabama	100	32.5	25	32.4	26.6	11.4	25.9	7.8
Alaska	100	62	62	31.9	21.6	17.3	16.2	1.6
Arizona	100	41	34	34.5	22.2	12.9	12.9	0
Arkansas	100	10.5	10.5	26.1	26.1	12.9	12.9	0
California	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Colorado	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Connecticut	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Delaware	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Florida	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Georgia	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Hawaii	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Idaho	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Illinois	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Indiana	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Iowa	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Kansas	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Louisiana	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Maine	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Maryland	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Massachusetts	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Michigan	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Minnesota	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Mississippi	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Missouri	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Montana	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Nebraska	100	12.5	12.5	23.5	23.5	17.3	17.3	0
New Hampshire	100	12.5	12.5	23.5	23.5	17.3	17.3	0
New Jersey	100	12.5	12.5	23.5	23.5	17.3	17.3	0
New Mexico	100	12.5	12.5	23.5	23.5	17.3	17.3	0
New York	100	12.5	12.5	23.5	23.5	17.3	17.3	0
North Carolina	100	12.5	12.5	23.5	23.5	17.3	17.3	0
North Dakota	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Ohio	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Oklahoma	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Oregon	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Pennsylvania	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Rhode Island	100	12.5	12.5	23.5	23.5	17.3	17.3	0
South Carolina	100	12.5	12.5	23.5	23.5	17.3	17.3	0
South Dakota	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Tennessee	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Texas	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Utah	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Virginia	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Washington	100	12.5	12.5	23.5	23.5	17.3	17.3	0
West Virginia	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Wisconsin	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Wyoming	100	12.5	12.5	23.5	23.5	17.3	17.3	0
Total	100	12.2	6.5	23.8	23.2	9.2	17.6	14

a. Includes motor fuel sales and motor vehicle and operation licenses.

b. Includes alcoholic beverage sales and licenses and tobacco sales.

c. Beach taxes only.

d. Tax on state board of education.

e. Includes related tobacco license tax.

f. Excludes corporations' excise taxes measured in part by net income and included in "Other."

g. On interest and dividend income only.

h. Corporations' income taxes included under individual income taxes.

i. Less than 0.1 percent.

Source: Compiled by Tax Foundation from U. S. Department of Commerce Data.

Table 5

## STATUS OF THREE MAJOR TAXES BY STATE

Selected Period 1939 - 1961

Legend: X, No Change; --, No Tax; R, Reduced Tax; N, New Tax; G, Extended Tax.

State	Personal Income				Corporate Income				Retail Sales and Use			
	1939- 1946	1947- 1950	1951- 1955	1956- 1961	1939- 1946	1947- 1950	1951- 1955	1956- 1961	1939- 1946	1947- 1950	1951- 1955	1956- 1961
Alabama												
Alaska												
Arizona												
Arkansas												
California												
Connecticut												
Delaware												
Florida												
Georgia												
Hawaii												
Idaho												
Illinois												
Indiana												
Iowa												
Kansas												
Kentucky												
Louisiana												
Maine												
Maryland												
Massachusetts												
Michigan												
Minnesota												
Mississippi												
Missouri												
Montana												
Nebraska												
Nevada												
New Hampshire <sup>a</sup>												
New Jersey												
New Mexico												
New York												
North Carolina												
North Dakota												
Ohio												
Oklahoma												
Oregon												
Pennsylvania												
Puerto Rico												
Rhode Island												
South Carolina												
South Dakota												
Tennessee <sup>b</sup>												
Texas												
Utah												
Vermont												
Virginia												
Washington												
West Virginia												
Wisconsin												
Wyoming												

<sup>a</sup> Gross tax substituted for net income tax.<sup>b</sup> Personal income tax on interest and dividend income only.<sup>c</sup> Applies to commercial only.<sup>d</sup> Jersey - New York area.<sup>e</sup> Sales tax effective from September 1, 1953 to August 31, 1955; reenacted.

Source: Compiled by Tax Foundation from Commerce Clearing House, Inc. Reports.

Table 6

Schmidli 111

Legend: X No Change - + Increase + Decrease - Same

E. Wentz & Subject to Rebuttal.

Source: Compiled by Tax Foundation from *Commerce Clearing House, Inc. Reports*.

addition of 12 retail sales taxes and the increase in rates of earlier taxes (Table 5).

Rhode Island's adoption of a corporation income tax in 1947 was the only one of the 29 major state taxes adopted in the decade ending in 1955 which had other than a consumption or use base. Since then new taxes on corporation net income have been adopted in 1958 by Delaware and New Jersey. In 1961 two states enacted taxes on personal income, the first such adoptions since 1937. West Virginia adopted a general tax, while New Jersey imposed a tax limited to commuters in the state to take advantage of the credit permitted by New York (Table 5).

For most of the period high-level employment enabled the states to finance unemployment benefits with payroll taxes substantially below the original 3 per cent. By 1961, however, demands had so increased that unemployment payroll tax rates were nearing, or above, all-time highs.

Traditionally, the states have been required to balance their budgets each budget period (usually a biennium). Many have been prohibited from incurring debt or greatly restricted in the amount and purpose of state-guaranteed debt. As expenditures in the postwar period rose more rapidly than tax revenues, some states turned to increased borrowing. Much of the debt, however, is of the non-guaranteed type, principally bonds issued by state turnpike and housing authorities.

From 1946 to 1960 the gross debt of state governments<sup>2</sup> and semi-autonomous state agencies tripled, reaching a total of \$18.5 billion at the end of 1960 (Table 3).<sup>3</sup> The largest increase has come since 1957, as the states have borrowed more than \$2 billion each year.<sup>4</sup> State borrowing is concentrated in less than one-fourth of the states. Nine states owe two-thirds of the total. Three states—California, New York and Pennsylvania—accounted for one-third of the \$2.3 billion (net) borrowed during 1960 by the states.

To summarize briefly, we can say that in the last 15 years state revenue systems have taken over more of the total job of financing state-local spending. This total job has more than tripled. To carry the increasing burden they have assumed, the states have adopted new taxes and raised the rates on those existing earlier—with one important exception. The property tax has been left for local use. The states rely heavily on broad-base taxes and also on selective taxes of various kinds. Virtually all state tax revenue today comes from taxes which were unknown to state systems at the beginning of this century. Finally, from one state to another differences between the relative roles of state and local<sup>5</sup> finances are substantial. Therefore, comparisons of state finances above are of much less significance than comparisons of the finances of state and local governments in each state.

<sup>2</sup>The net amount outstanding was \$15.6 billion.

<sup>3</sup>The net increase has been over \$1.4 billion per year.

### III. CRITERIA FOR JUDGING A REVENUE SYSTEM

What features make one revenue system better than another? What are the criteria to be used in judging a tax system?

Evaluation of criteria can benefit from a far more extensive summary of economic elements than is possible here. Five points, however, are too important to overlook in even a highly condensed discussion of criteria.

1. Taxes are paid by *people*—not by “real estate,” “gasoline,” “business,” or any inanimate thing. A tax collected from a corporation is, in any significant sense, paid by customers, employees or other suppliers, or stockholders (in the form of a reduction in either dividends or net worth).

2. Although there is truth in the assertion that everyone's taxes must really be paid out of his income, this fact does not mean that income is necessarily the best basis for all taxation. The income a person receives is the market's measure of the worth of what he and his property have produced, i.e. put into the economy. His spending for consumption is the measure of what he takes from the production of the rest of the economy. Taxes based on income are taxes governed largely by the value of contributions to society. Taxes based on expenditure are levies governed by what a person uses up or withdraws from the economy.

3. Present costs of government are so high that taxes inevitably have an important impact upon everyone. The average—about \$780 per capita—is higher than some

people can pay; it is above what others can reasonably be expected to bear. Consequently, some people must pay more than others. In deciding how the heavy costs are to be shared, the public faces difficult problems of achieving “justice.”

4. High tax rates in themselves—disregarding the amounts they take from the people—produce bad effects. When the rate is high, efforts to escape tax become worthwhile. Individuals and businesses will take what would otherwise be a second, third, or fourth choice in their investment, consumption, or business decisions if by doing so they can save a heavy tax. High rates applied to a small base invite the manipulation of the base. Economic distortions result. What determines the height of tax rates? The level of spending is obviously of prime importance, but the size of the tax base is also crucial. The broader the base, the lower the tax rate needed to produce any given volume of revenue. The broader the base, the greater the difficulty of manipulating it to save any substantial portion of the tax.

5. The size of the taxing jurisdiction profoundly influences the choices it can make among revenue sources. Therefore, the criteria properly used in evaluating a state revenue system differ from those appropriate when either national or local systems are considered. Yet each tax at each level of government must be judged as part of the whole system of public finance. This system includes government spending, an element which the public must always keep in view when examining the tax system.

#### A. REVENUE

The chief job of a tax system is to bring *adequate* revenues. Each particular tax must be judged first on the basis of its revenue potential, and this involves chiefly the breadth of its base. Large expenditures call for taxes with broad bases.

Revenue *stability* is important for states and localities. Most state-local expenditures (except capital outlays) fluctuate little from year to year. Paying for them requires revenues which are also highly stable during busi-

ness fluctuations. A drop in revenues during recessions may not only force curtailment of normal operations but also prevent states and localities from providing adequately for the increase in relief loads. Exceptionally high revenues during boom times invite wasteful spending. Of course, reduction in tax rates or in debt is always possible. So is the accumulation of surplus. However, the money on hand is likely to become, soon, money spent—perhaps even the start of a new program or a permanent expansion of one already established.

#### B. DISTRIBUTION OF TAX BURDENS

##### Fairness, Justice, Equity

All of us agree that where taxes are involved, fairness is of paramount importance. However, we run into difficulty in trying to define what we mean by such essen-

tially interchangeable terms as “fairness,” “justice,” and “equity.”

1. On one aspect of equity there will be a consensus. “Every taxpayer shall be treated according to legal rules

which apply equally to all taxpayers in the same class." Fairness requires that there be no prejudice, whether by accident or design, in the application or administration of the law.

2. Widespread agreement can be expected on another concept—*horizontal equity*. "Equals shall be treated equally." Everyone on the same income level or consuming about the same things, and otherwise in essentially similar circumstances, shall bear the same portion of the expense of government. When their circumstances differ in ways that are significant for the sharing of the costs of government—size of family or total of medical expenditures, for example—fairness requires that tax loads differ.

3. The difficult problems that then arise are those which involve *vertical equity*. *How much of what* differences will warrant *how much* difference in tax? There is little consensus in answering this question, but the unequal treatment of taxpayers must rest on reasonable, not capricious, bases.

Throughout much of the Western world there has grown up a general notion that tax burdens should reflect "ability to pay." This concept, however, is about as unclear as "fairness." There is also wide acceptance of the idea that the tax system should be progressive. What basis is there for deciding how much more in taxes it is fair to demand from the family with an income of \$10,000 than from the almost similarly situated family with \$9,800 or the very differently situated family with \$8,000 or \$12,000? Ardent supporters of progression as a device for discriminating fairly may disagree strongly on the fairness of a given set of rates. When does increasingly steep rate progression become unfair?

Some advocates of progression make much of the point that reducing economic inequality is socially desirable. Whatever reasons can be cited for this argument in judging Federal taxes, it cannot have appreciable weight at the state level. Imagine, for example, a state trying to discriminate against upper income and wealth groups heavily enough to reduce inequality significantly. An exodus, more gradual than sudden, of people of wealth and talent would largely defeat the attempts.<sup>4</sup>

#### Benefits from Government Spending as a Basis for Taxation

Another basis for differentiating tax burdens may be the government services received—the benefit principle. Although governmental spending is presumably done to further the *general* public interest, individuals as such do benefit from some expenditures, and some individuals

<sup>4</sup> The apparent exception in state death taxes rests largely on the Federal credit.

more than others. On occasion, these benefits can serve as an equitable basis for imposing a tax.

Motor fuel and license taxes and the part of the social security payroll taxes on the employee are commonly justified on the benefit basis. Perhaps more significant is another aspect of benefit. Residents of some communities pay higher taxes than residents of others because of differences in the government services received. The same applies at the state level. One merit of decentralization in government is that it offers more opportunity than does a centralized system for people to decide freely whether the benefits of certain public expenditures are worth their cost.

#### Shifting Taxes to People Outside the State

States have tried to take advantage of the possibilities of passing some of their tax burden to outsiders. One kind of opportunity arises from the deductibility provided in Federal tax laws. Rational self-interest requires every state to consider carefully all the opportunities Congress allows. A second type of opportunity to shift burdens to persons outside the state appears chiefly in taxes which fall initially on businesses. Property taxes on railroad terminal property may bring far more revenue than local residents can possibly be said to bear. At least a portion of state income, property, excise and payroll taxes on business firms, especially levies on the biggest companies, are widely diffused among consumers and stockholders over much or all of the country. Non-residents also pay part of the individual income and inheritance and estate taxes collected by many states. Tourists pay sales and excise taxes. In general, however, the ability to shift taxes to residents of other states is limited. Caution should take precedence over greed.

#### Other Considerations Affecting the Distribution of Tax Burdens

Four mere points deserve mention. (1) Differences in taxes are justified in some cases by the desire to influence production and consumption in the interest of the general welfare—philanthropic exemptions offer one example, high rates on whisky another. (2) Unfortunately, conclusions about how taxes are in fact shared among members of the community are always tentative. Our knowledge of shifting—especially of taxes on business—is far from satisfactory. (3) One explanation of differences in the sharing of taxes is that political power is unequal. The scale of progression of an income tax, for example, may rest in part upon the fact that the higher the position in the income scale, the fewer the voters. (4) An ideal tax would create no serious hardship. In the real world, unfortunately, hard cases are to be expected. They deserve attention. But they must not dominate. A tax law designed specifically to meet the unusual situation will have unwelcome results as it applies more broadly.

## C. ECONOMIC EFFICIENCY

### Keeping Allocation Distortions at a Minimum

Efficiency in the allocation of productive resources (human and material) is important in advancing the general welfare. Taxes affect resource allocation. The general objective should be taxes which hinder as little as possible the efficient operation of free markets. As a general principle, taxes should be neutral or impartial in their effects on resource allocation—among private industries, regions, occupations, methods of operation, forms of organization, and so on.

The inevitable repressive effects of a tax should interfere as little as possible with the accomplishment of governmental objectives of the public. For example, if the improvement of transportation is a goal of public policy, as evidenced by highway spending, taxes which burden railroads may quite probably aggravate the difficulty the expenditure seeks to alleviate.

Where for some persuasive reason interference with the market economy seems likely to serve the public interest, tax discriminations may be devised to alter resource allocation. Taxes may, on occasion, serve a useful regulatory purpose—though, of course, they may also regulate harmfully.

### "Business" as an Object of Taxation

Although "business" is a favorite object of taxation, one can well ask, "Why"? Business is our major agency for organizing to produce—for allocating productive capacity and its use today and for undertaking economic growth. Businesses are groups of people seeking to benefit themselves by serving others. Taxes are not likely to help business serve efficiently in producing.

Broadly, the public interest calls on each business (1) to turn out products or services which are wanted more than something else, as reflected in freely made consumer decisions expressed in the market or through governmental agencies and (2) to use methods which economize on labor, materials, capital, and other "inputs" according to their relative scarcity and productivity.

However, taxes on business do not improve the process by which consumers indicate their desires. Furthermore, business taxes do not help indicate to managers which inputs most need economizing. A business has an incentive to save on taxes. Unfortunately, in adopting methods which cut the tax bill, it may not operate more efficiently in the sense of less labor or fewer materials per unit of output. A business, in fact, may wisely adopt methods which are inherently second choice because the artificial factor of taxes makes such methods best under the circumstances.

The broad public interest would be advanced by generally freeing business decisions from most tax consid-

erations.<sup>1</sup> Exceptions may appear if business as such puts government in special costs—or receives special benefits from expenditures. Except for highways, examples at the state level are rarely important.

In contrast with the days when our economy was predominantly agricultural, those persons who today make decisions about where to produce have some choice about where to locate. Taxes and governmental services are among the factors which influence decisions on business location. High taxes are certainly not a favorable element unless they finance governmental services which either facilitate economic activity or appeal to the people who must foot the bill.

### Influence on the Demand for Government Service

In free markets it is prices which make buyers aware of cost and which induce economizing. Revenue sources have a comparable job as regards government spending.

Sometimes a government may charge for a service in a way that influences the quantity demanded, for example, tuition in universities. The charge not only collects revenue; it can also reduce the need for government to spend to provide the function. States have few opportunities to use what is essentially pricing for the dual objective of getting revenue and reducing expenditure. Nevertheless, occasional reexamination of the entire range of possibilities is in order.

Taxes also have a job to do in alerting citizens to the costs of government. Taxes which make the public aware of what it is paying for governmental services can help in comparing the worth of the services received with the money sacrificed to pay for them. Every citizen should be made to recognize the fact that he pays taxes. Otherwise the sense of political responsibility will not develop adequately.

### Certainty

Tax statutes, regulations, and administration should be reasonably stable in their basic elements. Otherwise, uncertainty about tax laws adds to the difficulties of business and personal planning for the future. Although it is not necessarily true that "an old tax is a good tax," the economy will have adjusted to it. A considerable degree of certainty in the tax system is desirable, especially when taxes are as heavy as they are today; otherwise, decision making becomes needlessly complicated, and efficiency suffers.

<sup>1</sup> The reduction in business taxes would presumably lead to an increase in taxes on individuals and thereby enlarge the influence of taxes on personal decisions. To some extent production as well as consumption would be involved. On the whole, however, the total effect on the creation of income would doubtless be less than when "business" pays the same total.