

COMMENTARY

Editorials, letters, columns and other opinions

Broadening Tax Revenue Base Would Help Cities



COMMENTARY

Gary London

This recession has laid bare some long-standing problems in our private and public sector financial system. If jurisdictions are allowed to broaden their tax revenue base, the effect would be the encouragement of

the kinds of higher density, mixed-use development needed in most communities.

Cities and other local jurisdictions have traditionally focused on retail for sales taxes, hotels for transient occupancy taxes, or TOT, and tax increment financing (property taxes) through redevelopment as the major tax sources to pay for their "general fund" operations. It is unusual for these revenue sources to decline, yet each source is dramatically down. Some of this tax revenue will eventually return. Alarmingly, some may not.

I want to focus on the alarms going off.

The "Great Recession" has set in motion two trends that may influence consumer behavior for a long time. Economists refer to these habit breaking events as structural changes. The first and largest trend is consumer spending. In the past three decades, personal consumption expenditures have risen from less than two-thirds of the nation's gross domestic product (total value of all goods and services produced in the U.S. in one year) to nearly 72 percent. In the same time period, personal savings fell from more than 10 percent of disposable income to about 1 percent. This increased consumption and reduced savings, coupled with an increased willingness to accept higher levels of debt and risk, likely helped fuel the last two asset bubbles: the dot-com stock and housing price bubbles. It's the bursting of the housing price bubble and decline in perceived wealth that may trigger the second change in trends: households' inability and/or unwillingness to tap their home equity to supplement their consumption.

As the recession gained in strength, home prices fell, reducing wealth. The unemployment rate rose, reducing household incomes, triggering a change in consumption habits and reducing retail sales by more than 10 percent and increasing the personal savings rate from 1 percent to 5 percent in a very short time period. With the exception of the short-term blip caused by the "cash for clunkers" program, retail sales are moving sideways from this new low base, while personal savings also seems to be holding steady at this higher level.

Demise Of Tax Revenues

The decline in retail sales not only means less tax revenue for state and local governments, it may also force some consolidation in number of retail outlets. The demise of auto dealerships is a good example of the permanent loss in value that many commercial properties are quite likely to experience. Throughout this region, auto dealership inventory is down about 25 percent. Closed auto dealerships are unlikely to come back.

This is an industry that is permanently downsizing. It serves no purpose for local jurisdictions to assume otherwise.

Yet, many local jurisdictions are reluctant to anticipate the inevitable demise of coveted tax revenues (1 percent) like auto dealerships, which have provided a lucrative and stable source of revenue for many years. It is not easy to accept the fact that what we are witnessing is a permanent change in the auto delivery system.

So what reaction can we expect? I can recall the Wal-Mart wars between the local cities as they competed to attract the retail giant to their local jurisdiction. Wal-Mart waved the tax revenue incentive in front of local officials. It's hard to fight that. And the cities have been right to welcome these revenues. Will cities fight to retain these lucrative, yet dwindling number of retail outlets?

In the coming years, there will be too much commercial property. People are spending less. There is too much retail. People are traveling less, lowering the demand for hotel rooms. What will these changing trends mean to the convention business? And the net impact will be the loss of viability for many of these commercial assets. This will not only prove problematic to their owners, but it will become a huge problem for the jurisdictions in which they reside, who depend upon them to bolster their revenues.

It is time to revisit the sources of public revenue. In light of the economic downturn we are experiencing, and the prospect that even with recovery many of these land uses are unsupportable, it should be evident to our civic leadership that revenues will be permanently diminished.

Yet, revenues must come from somewhere, and they need to be less volatile. It is extremely unlikely that taxes can be raised. The electorate resists tax increases in good times. They would be very reluctant to approve new taxes in this economic environment.

Cutthroat Competition

The only real choice is to find other sources of revenue. There are good ideas. One of the best economic ideas guys in San Diego is Marney Cox, chief economist of the San Diego Association of Governments, or Sandag, who has been thinking about all things fiscal for 30 years.

The effect of the dependence of the traditional sources of property taxes, sales taxes, tax increment financing and TOT is the "fiscalization" of land uses, argues Cox. Because of the enormous amounts of tax revenues that can be achieved by these types of land uses, there is a built-in bias on the part of local jurisdictions to want more of them. But that's not all, he explains, "The current tax system encourages (forces really) cities to engage in cutthroat competition for the weakest contributors to economic prosperity — retail outlets — while discouraging the construction of less fiscally attractive uses such as homes and industrial/business parks."

Cox is blunt about how to solve the

volatility issue; simply, we need to broaden the tax base (increasing the number of contributors). One way to accomplish this is to levy sales taxes on services. As our economy has evolved to become more service based, our tax system should evolve with it. By broadening the tax base, it may also be possible to lower the sales tax rate, or start the tax rate on services at a low level and raise it slowly each year to a specified rate. Cox believes that all cities, and especially those with large retail bases, will want to make sure that their existing sales tax base and revenue are not jeopardized. Cox thinks this can be accomplished.

Making People Popular

To balance the fiscalization of land-use problems requires that the sales tax revenue collected from services needs to be distributed not back to the site where the service was purchased, but on a per capita basis. The purpose of the per capita distribution is to allow the revenue to flow back to communities where people live and where their jurisdiction is providing the public facilities and services that the revenue will pay for. Distributing tax revenue on a per capita basis will help make having people popular, and remove some of the resistance that has built up against housing.

Another proposal, according to Cox, that has the potential to reform our tax system has recently been released by the Commission on the 21st Century Economy — also known as the Parsky Commission. The heart of this proposal is a net business receipts tax or value-added tax. This NBRT, as proposed, would be levied on all business activity, making its base very broad and helping reduce revenue volatility. The tax rate would be applied to the net receipts of each business — determined by subtracting purchases from other firms from gross receipts. The commission's report, according to Cox, goes on to suggest that the net business receipts tax rate could be 4 percent or lower and we could substantially reduce or eliminate other more narrowly based taxes such as the state portion of the sales tax (normally 5 percent), the state personal income tax, and the corporate tax. More importantly, the fiscalization or attractiveness of the land use would be based on the value added by the business. In other words, the more productive the business, the greater the value added, providing a boost to a community's economic prosperity and standard of living.

One final adjustment that Cox would like to see that is not in the commission's report is to adjust how the tax revenue is allocated. According to Cox, "To ensure people and houses are as attractive as other uses, we need a tax revenue distribution system that allows these revenues to flow back to the communities where the costs are being borne."

Fiscal reform proposals like these will go a long way toward silencing the budget alarms going off in most, if not all, of the state legislative and local council chambers.

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