The Historical Evolution of State and Local Tax Systems

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Abstract

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This survey of state and local tax system evolution extends from the Colonial era to the present. State governments, the primary tax innovators, developed numerous tax alternatives that have supplemented or supplanted property taxation. Constrained by unsuccessful tax innovation since the Great Depression, future revenue-raising possibilities for states and localities will continue to rest on base-broadening activity, raising existing tax rates, and tax diversification efforts that will be significantly supplemented by non-tax revenues.

State and local government officials will foreseeably struggle with increasingly difficult expenditure choices--particularly for education, corrections, welfare, and health programs--as federal support for domestic activities declines, discontent with burdensome taxes rises, frustration with mandated expenditures increases, and relatively slow economic growth unfolds. Thus, major state (i.e. income and sales) and local (i.e. property) tax bases will face intensified pressure. Federal adoption of a flat-rate income tax could possibly undermine further the efficacy of these tax bases if state and local income and property tax deductibility was eliminated.

Scholarly literature has afforded surprisingly little attention in recent decades to the origins of state and local tax systems--particularly those that occurred before this century. An appreciation of the historical forces governing tax base evolution not only can assist in understanding the emergence of the present structure, but also can illuminate consideration of any proposed tax policy changes intended to augment future revenue requirements.

This article will explore the economic, political, and administrative determinants that have historically affected tax base adoptions by the states--the major innovators. The main economic and political determinants have included: (1) changes in economic activity, (2) economic crises, (3) increased revenue needs to meet existing and expanding public service demands, (4) political opportunities for tax base adoptions, and (5) possibilities for "tax exporting". Many of these considerations will likely influence future evolutionary changes in state and local tax systems.

(TABLE 1 ABOUT HERE)

Table 1 shows the year that pioneering states adopted notable sources of taxation enacted since 1789. Property, poll, license, and excise taxation began in the colonial era.

The Colonial Era

Colonial life principally revolved around agricultural activity with increasing attention to commercial and artisan pursuits. Colonial governmental needs were very limited--mainly general administration, roads, and jails. The colonists generally disdained taxes and preferred fees, fines, and personal services. When tax revenue needs were urgent, regional attitudes helped govern the mix of sources. The New England colonies primarily relied on property and poll taxes; the southern colonies on customs duties and poll taxes (given that large landholders disliked property taxes); and the middle colonies on property taxes, customs duties, and excises (Dewey, 1968:10).

Virginia, the earliest settlement (1607) levied the first known colonial tax--a poll (head) tax in 1619 (Sydenstricker, 1915:5). The ubiquitous poll tax, New York being the only exception, applied to free men regardless of occupation or the amount of property holdings. Poll taxes on slaves, however, formed part of the personal property tax. Although the poll tax was simply stated and easily administered, it could be burdensome for those with relatively low incomes.

Virginia quickly recognized the possibility of taxing property by levying a tax on the estate of deceased persons still liable for unpaid poll taxes (Kendrick, 1951:99). The Massachusetts Bay Colony went further by imposing a tax directly on "estate" property in 1634. As forms of property ownership widened, through expanded economic activity, the property tax moved

beyond land to include buildings, livestock, and other enumerated tangible personal property items. Local administrators arbitrarily assessed all of these components to which differentiated tax rates applied for generating colonial and local government revenues (Jensen, 1931:27).

The Plymouth colonists supplemented the property tax with a "faculty" tax in 1643 that was later adopted by most of the other colonies (Kinsman, 1902:2). Generally, a fixed rate applied to the estimated earnings (i.e. wages, profits, and other income) of all members of a particular profession (Kinsman, 1903:16). Connecticut, Massachusetts, and South Carolina especially derived significant revenues from its use. Although the faculty tax was crudely applied, it recognized that compensations received outside of property holdings also represented tax-paying ability. Customs duties were imposed on a variety of enumerated exports and imports that included: tobacco, wheat, wood products, and spirits. Massachusetts, New York, South Carolina, and Virginia became more heavily dependent on these revenues as the colonial period progressed (Myers, 1970:18-20). License taxation began with levies on the beaver (1632) and fur trades (1641) in Massachusetts, but all of the colonies eventually extended them to occupational groups (e.g. tavernkeepers and peddlers). Finally, excise or consumption taxes were levied on both widely-consumed (e.g. wine and spirits) and certain luxury goods (e.g. carriages and fruits).

Colonial tax payments were made in various forms-personal services, commodities, specie, land grants, and paper money--to local administrators, who often contended with tax evasion (Kendrick, 1951:108).

As the colonial period ended, the colonists had succeeded in developing several different tax bases, with provisions and enforcement procedures that were uneven within and among the colonies--characteristic features of future tax systems. The faculty tax, a harbinger of the income tax, was the most important innovation in tax base development.

Reliance on the General Property Tax

Aside from the loss of revenues from customs duties with the ratification of the U.S. Constitution in 1789, regional state tax systems remained as in the colonial era. Oliver Wolcott surveyed the tax systems of the sixteen extant states in 1796, especially property tax usage. He observed that real property components (i.e. land and buildings) constituted most of the property tax base, supplemented by enumerated tangible (e.g. household possessions) and intangible (e.g. interest on loans) items. Arbitrary assessment procedures, numerous tax rates, and various exemptions still plagued local property tax administration. Four states, nevertheless, (Delaware, Maryland, New York, and Rhode Island) attempted to tax the "mass of property" (Wolcott, 1832:437).

Three of these states used the property tax only sporadically. Maryland (1756; 1777-1785) levied it mainly to finance the Revolutionary War (Hanna, 1907: 11-13). Pennsylvania (1785-1789), Delaware (1798-1804), and New York (1799-1802) used it either because other tax and non-tax revenues were insufficient to cover expenses or to finance debt (Newcomer, 1917:31, 37, 54). Otherwise, license taxes, public land sales, and income from state investments generally

provided needed revenue.

Poll tax usage tended to decline, except in North Carolina, during the early decades of nationhood because of equity considerations. Faculty tax experiments in New York (1778-?), New Hampshire (1719-1794), Maryland (1777-1780), Virginia (1777-1790), Delaware (1796-1800), Vermont (1778-1840), and Pennsylvania (1782-?) generated little revenue (Kinsman, 1903:9-14).

State expenditures, mainly for the same purposes as in the colonial era, were easily financed from these long-standing tax and/or non-tax sources from 1789 to about 1820 when the era of "internal improvements" began. As agricultural and commercial markets expanded westward in this period, banks and insurance companies emerged to facilitate economic relations. These early corporate entities, considered legal persons, were subject to real property taxes in all states. Some states, inaugurating specialized corporate taxation, imposed taxes on various forms of intangible personalty. Bank capital stock taxes were levied in Georgia (1805), New Jersey (1810), and Massachusetts (1812), while Pennsylvania (1814) and Ohio (1815) enacted bank dividend taxes (Seligman, 1921:151). New York (1824), and New Jersey (1826) commenced insurance company taxation by taxing foreign (i.e. out-of-state) insurance premiums (Seligman, 1921:161).

Recognizing that the federal government had limited interest in fostering "internal improvements" and state tax revenues would be insufficient, many states borrowed heavily from about 1820 until the Panic of 1837 to finance large-scale, risky investments in canals, railroads,

and banks in an effort to link scattered markets and boost prosperity. Unable to meet interest and principal payments from defaulting bonds as a result of the Panic of 1837, many states reluctantly raised property taxes, expanded special corporate and license taxes, and even experimented with inheritance and income taxes (Taylor, 1951:376).

Virginia initiated taxation of transportation companies in 1842 with a tax on "dividends of profit" (Sydenstricker, 1915:32). Connecticut followed with a tax on non-residential owners of railroad stock in 1849 (State of Connecticut, 1913:23). Inheritance taxation began in Pennsylvania (1826) and Louisiana (1828) and later spread to Virginia (1844), Maryland (1845), North Carolina (1847), and Alabama (1848) (Kendrick, 1951:117). Restricted income taxation commenced in Pennsylvania (1840), Maryland (1842), Virginia (1843), Alabama (1843), and Florida (1845), but difficulties with local administration of the tax (e.g. viewed as akin to intangible property taxation) constrained collections (Penniman and Heller, 1959:3-4).

Meanwhile, several states, around 1820, initiated a significant reform in property taxation through a "general property" tax. The "general property" tax attempted to impose a uniform tax rate on all forms of property subject to taxation (uniformity and universality provisions) through constitutional or statutory means--reflecting the Jacksonian belief that the actual value of property best represented tax-paying ability (Benson, 1965: 32-35). However, unlike land, tangible and intangible personal property was mobile and became harder to locate for tax purposes (Fisher, 1987:108). As the process of industrialization unfolded around mid-century, general property tax complaints became more widespread as critics argued that increasing

amounts of household and business property were either exempt from taxation, underreported, or underassessed (e.g. diverse forms of business intangible personalty such as stocks and bonds). The results were inequitable tax burdens within and among property classes (i.e. residential, commercial, and industrial). One notable response was the initiation of state assessment of railroad, express, and telegraph property in the two decades after the Civil War that often resulted in modified general property and other special taxes (Lutz, 1918:34). Moving beyond state taxation of railroad dividends and stock, Wisconsin levied a gross receipts tax on railroads in 1854 (Kendrick, 1951:116). Special taxation of express and telegraph companies began when Virginia imposed gross receipts taxes on express companies in 1856 and Georgia levied a gross annual profits tax in 1858 (Corporation Commissioner, 1915:58, 130). Ohio taxed the net receipts of express and telegraph companies in 1862 (Corporations Commissioner, 1911:32). Gross receipts and other specialized corporate taxes were later extended to telephone, gas, and electric utilities in the last quarter of the nineteenth century.

The 1870 federal census first confirmed the pre-eminence of the state general property tax in state tax structures. Six states (Connecticut, Delaware, Maryland, Massachusetts, New Jersey, and Pennsylvania), however, obtained more than one-half of their total tax revenues from specialized corporate and/or license taxes (U.S. Bureau of the Census, 1872).

Following a period of restrictive state spending in the middle decades, associated with heavy debt burdens, state expenditures accelerated in the last two decades of the nineteenth century. These expenditures were mainly for health, corrections, social welfare, and educational

activities as population growth expanded and concentrated in urban areas to meet the demands of a burgeoning industrial economy.

Permanent state tax commissions appeared after 1890 and were variously charged with collecting non-property taxes, equalizing the burden of the state property tax, assessment of public utilities, and supervision of local assessors (Kendrick, 1951:121).

Approximately one-third of the states derived more than fifty percent of their total state tax revenues from non-general property taxes by 1902. Most of these states had gradually embraced a "separation of revenue sources" movement that relegated the general property tax to local usage. A portion of these state-administered special taxes was often returned to localities through state aid or tax sharing payments (Hutchinson, 1931:14).

New York, illustrative of the extended reach of specialized taxation in the late nineteenth century, levied a franchise capital stock tax on certain corporations and joint-stock companies and taxes on insurance premiums in 1880. Additional taxes were placed on collateral heirs (1885), business organization (1886), liquor (1896), and gross earnings and excess dividends of certain public utilities in 1899 (Newcomer, 1917:59-64).

State Income and Sales Taxes

The continued failure to reach intangibles near the turn of the twentieth century led many states to adopt classified property taxes (i.e. lower rates on intangibles than real property). Alternatively, other states attempted to reach intangibles through income taxation. The 1911

Wisconsin income tax law, the first modern statute, levied state-administered rates on individuals and corporations based on "information returns" filed by businesses that detailed various forms of income payments (Penniman, 1980:9). Income taxes were quickly adopted in Mississippi (1912), Connecticut (1915), Virginia (1915), Massachusetts (1916), Delaware (1917), Missouri (1917), Montana (1917), North Carolina (1919), North Dakota (1919), and New York (1919). Rising property tax rates in the 1920's, significant property tax delinquencies in the 1930's, and further efforts to reach intangibles prompted further adoptions--such that thirty-three states had an individual and/or corporate income tax by 1940 (Blakey, 1941:131). Connecticut, in 1991, became the forty-first state to tax wage and salary income.

State income tax usage accelerated the movement toward less dependence on the real general property tax. A majority of states received more than fifty percent of their total tax revenue from specialized corporate, special property, mortgage, inheritance, poll, business license, and income taxes for the first time in 1924 (U.S. Bureau of the Census, 1926:72-75).

The income tax became a major tax source in succeeding decades by generating substantial amounts of revenue in periods of inflation and economic growth (i.e. a relatively elastic revenue source), either with modestly flat or progressive rates. The adoption of withholding payments (after World War II) and conformity with federal income tax provisions greatly aided state administration.

Excise taxes, traceable to the colonial era, were further applied to motor fuels, cigarettes, and liquor in the early decades of the twentieth century. Motor fuel taxation began in 1919

(Colorado, New Mexico, North Dakota, and Oregon) and spread to all states within ten years. Motor fuel taxes dominated total state tax revenues from 1927-44, before being superseded by the general retail sales tax. Iowa pioneered the cigarette tax in 1921, which forty-three states adopted by 1950. Thirty states enacted distilled spirits taxes from 1933-40 after the end of Prohibition (ACIR, 1994).

Although revenue from motor fuel taxes increased, corporate income and property tax receipts significantly declined in the early years of the Great Depression. Consequently, state governments desperately needed a new tax source to finance their expenditures, provide aid to localities (especially for social welfare), and participate in federal aid programs. The general retail sales tax, with its broad base and relatively low yield, proved a successful experiment. Mississippi (1932) pioneered this tax, which twenty-one states employed by 1938. Additional enactments after World War II mainly financed educational programs, as states became reluctant to raise income tax rates (Due and Mikesell, 1994:2). Critics have argued that its regressiveness (i.e. it claims a disproportionate share of spending by lower income groups), relatively inelastic nature (i.e. its revenue yield lags economic growth), and applicability mainly to goods has tended to offset its major revenue-raising capability.

Changing economic conditions and improved administrative capability may create possibilities for new state tax bases, but favorable political opportunities are also necessary for tax adoptions. A recent empirical study (Berry and Berry, 1992:715) contends that twentieth century state tax adoptions generally resulted from either a fiscal crisis, a political willingness to

enact a tax in the year immediately after an election, or an inclination to "copycat" other states. Little empirical support could be found for the hypotheses that tax adoptions were more likely to occur in states with a high level of economic development (i.e. greater wealth or urbanization) or a government unified politically (i.e. the same political party controlled the governorship and legislature).

Recent empirical evidence shows that "tax exporting" (i.e. shifting part of a state tax burden to nonresidents) may also influence state tax structure choices. States tend to shift the burden of state income and business property taxes when large corporate tax bases are owned by nonresidents (Morgan and Mutti, 1985:195-199). Further, states with significant tourism and natural resource industries tend to rely more on license and severance taxes, respectively, than on income and general sales taxes (Gade and Adkins, 1990: 44-45). Severance taxes, exactions based on the value or quantity of natural resources removed from land or water, are relatively important in only a few states. Alaska, Louisiana, Montana, New Mexico, North Dakota, and Wyoming received at least ten percent of their total tax revenue from these taxes in 1992 (U.S. Bureau of the Census, 1994).

Local Tax Revenue Diversification

The property tax historically has been the main source of local government tax revenue. Most of the relative decline since the 1930's in the property tax share of total local government tax revenue nationally has resulted from greater reliance on local general sales and income taxes-

-especially for counties and large cities.

Local general sales taxes, first adopted in New York City (1934) and New Orleans (1936), came after rising discontent over property tax increases accentuated by foreclosures. By 1994 thirty-three states had authorized local sales tax options that were state-administered in twenty-six states, locally-administered in three states, and both state and locally-administered in four states (Due and Mikesell, 1994: 279).

Local income taxation first emerged in Philadelphia (1938), St. Louis (1948), Cincinnati (1954), Pittsburgh (1954), and Detroit (1962). Income taxes were used by 3,853 local jurisdictions in 1992, particularly in Pennsylvania and Ohio (ACIR, 1994: 77).

Other General Revenues

State and local governments have also derived revenues from "charges and miscellaneous general revenues," according to federal government statisticians. Since 1790 state financial support has included revenue from: public land sales, investment income, bank dividends, premiums from bank charters, loan payments, war claims, earnings from prison-made goods, tolls, sales of public documents, fees, fines, forfeitures, lottery sales, and numerous smaller receipts. New York and Pennsylvania, especially adverse to taxation, received one-half or more of their general revenue from such sources in the first decades of nationhood. In more recent decades, education and hospital charges and interest earnings have become increasingly important in many states.

Intergovernmental assistance payments--federal aid to states and localities and state aid to local units--rose significantly in the 1930's and again in the 1960's and 1970's, but inflation-adjusted growth in overall federal aid payments has trended downward since 1978. Most federal assistance is currently geared toward health (especially Medicaid), income security, education, and highways that often requires further state contributions (Raimondo, 1992: 234).

Some Lessons from the Past

State government tax base innovations, and subsequent court decisions and statutory changes, have traditionally reflected the political willingness and administrative capability to exploit market-induced economic activity. As the dominant nature of market activity has changed from agricultural to industrial to service pursuits, the states have had to rely mainly on regressive tax sources (except for modestly progressive state income taxes) that have often limited their ability to meet increased expenditure demands.

Significant changes in economic activity have historically generated potentially taxable components for major tax bases (e.g. tangible and intangible personal property and services that could be reached under the general sales tax). Political willingness and state administrative capability consequently determined the extent to which these components were to be exploited. For example, the general property tax attempted, but subsequently failed, to embrace numerous forms of personalty. Eventually enhanced state administrative capability made possible the development of specialized corporate, income, and general sales taxation as relatively effective

alternatives to personal property taxation--perhaps the most important general property tax reforms (Reeb and Tomson, 1985:476). However, major tax bases never have embraced all existing possibilities either because they have been legislatively excluded or have fallen short of coverage. The property tax has historically excluded religious, governmental, and not-for-profit organizations. The general sales tax has not reached all existing service activities in most states.

The existence of a major tax base, however, has not guaranteed its usage. The state property tax was not universally employed in the early decades of nationhood. Currently, seven states (Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming) do not use an individual income tax. Five states (Alaska, Delaware, Montana, New Hampshire, and Oregon) do not employ a general retail sales tax (ACIR, 1994:34).

General property, income, motor fuel, and general retail sales taxes have been the only major broad-based exactions since 1789. The general retail sales tax, enacted over sixty years ago, was the last major innovation. The subsequent failure to develop a major tax source since the Great Depression is an unheralded constraint.

The federal government, adhering to a principle of neutrality, has generally avoided efforts to assist states in bolstering their revenues from existing tax sources. However, state inheritance taxation was strengthened through allowance of a partial tax credit against the federal estate tax in the 1920's (Shannon, 1969:107). Itemized deductions under the federal individual income tax for allowable state and local income and property taxes has long encouraged reliance on those tax sources. More recently, state enforcement of a 1978 federal law prohibiting cigarette

"bootlegging" has greatly reduced revenue losses from illegal cigarette sales (Fisher, 1996: 401-402). Barring a voluntary agreement among the states, future state sales tax revenue would greatly benefit from federal legislation permitting state use taxation of national sales by mail-order firms.

State and local tax revenues over the last half-century have generally expanded incrementally through a variety of initiatives that are indicative of future changes. These past actions have mainly included: limited base-broadening activity, raising existing tax rates, and some tax diversification efforts.

Future Tax Policy Developments

State and local tax systems have never fully adapted to an economy dominated by services, so broadening the base of sales and income taxes offers considerable potential for future revenue-raising efforts.

Base-broadening activity can forestall tax rate increases, ease compliance problems, simplify tax administration, improve fairness to taxpayers, and enhance the elasticity of the tax system to take advantage of economic growth (Gold, 1990: 111-112). The greatest potential gains in sales tax revenue appear to be in health, professional, and business-related services that are currently precluded by political considerations (Due and Mikesell, 1994: 92). Broadened sales taxation of public utility, repair, and personal services, plus further taxation of admissions and amusements, appears more politically feasible (National Conference of State Legislatures

and the National Governors' Association, 1993: 74). Increased attention is also expected to focus on: sports betting, automatic teller machines, security and maintenance services, and wireless communications. A few states (Hawaii, New Mexico, and South Dakota) already have extensive general sales taxation of consumer and business services.

Increased sales taxation of interstate business services will depend on further state cooperative efforts. For example, a particular need for cooperation exists where a service, such as accounting or on-line computer services, originating in one state is provided in several states and tax apportionment becomes difficult (NCSL-NGA, 1993: 73).

Future state personal income tax reforms geared toward revenue growth will likely include repealing or modifying allowed deductions. States that have already repealed various deductions include: Kansas (1992) and Kentucky (1990)--federal income taxes; Colorado (1992) and Mississippi (1992)--state income taxes; and New Jersey (1990)--property taxes (Gold and McCormick, 1994: 11).

Increased income tax revenues from multistate corporations could be achieved in several ways: adoption of a "combined reporting" basis (i.e. inclusion of all corporate subsidiaries of a firm) for apportionment of corporate income tax payments; revision of the components used in an apportionment formula (e.g. include a "market-based" factor to allow states that provide services to out-of-state firms to tax part of their net income); and better coordination by states of their corporate tax policies (NCSL-NGA, 1993: 37, 43).

States will continue to allow local option sales taxes that often specify the usage of the

proceeds. The intent is to alleviate pressure on the property tax, keep overall tax rates lower, and create a somewhat more elastic revenue structure. Recent efforts include: Kansas (1992), where counties and cities may impose a sales tax for health programs; Missouri (1993), where counties can use the proceeds for emergency 911 numbers; and Washington (1993), where counties can use the revenue for criminal justice programs. Chicago (1991) and Philadelphia (1991) recently enacted a sales tax (Gold and Ritchie, 1994: 19).

States could also augment local revenues by changing their shared tax formulas. Missouri (1993) and Montana (1993) recently provided localities with a greater amount of shared revenue from a motor fuel tax (Gold and Ritchie, 1994: 33-34).

A value-added business tax (VAT) has long been suggested as a new state tax base, but states have shown limited interest. A relatively low tax rate would be applicable to all businesses at each stage in the production and distribution of goods and services. Advocates say this could generate substantial revenue, resolve several corporate taxation apportionment problems, replace many existing business taxes, and reach most service activity. Critics argue that administrative interstate complications could be very serious due to any differences in coverage, exemptions, and rates among the states. Michigan, the only state with a variation of VAT, has had its "single business tax" since 1975. Alabama, Florida, Tennessee, and Texas have recently debated, but not enacted, some form of VAT (Brown, 1991 :1).

Finally, state and local charges and miscellaneous general revenues will continue to expand and supplement tax sources. At the state level, there has been widespread application of

environmental fees affecting solid and hazardous wastes and containers. At the local level, "impact fees" have been imposed on developers to help defray infrastructure expenditures. In some localities, charges have been levied for fire protection and ambulance usage (Downing, 1992: 523-525).

One of the fastest growing components of miscellaneous general revenue in recent years has been legalization of various types of gambling--lottery sales, parimutuel offtrack betting, casinos, bingo, and video machines (Katz, 1991: 17-70). Nevertheless, gambling revenues will remain a minor revenue source for most states.

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TABLE 1

IMPORTANT TAX ADOPTIONS BY STATES

TAX	YEAR	STATE(S)
Specialized Corporate		
(Bank)	1805	Georgia
(Foreign Insurance)	1824	New York
Inheritance	1826	Pennsylvania
Income (Modern)	1911	Wisconsin
Severance	1915	California
Selective Sales		
(Motor Fuel)	1919	Colorado, New Mexico, North Dakota, Oregon
(Cigarette)	1921	Iowa
(Distilled Spirits)	1933	Arizona, Colorado, Delaware, Indiana, Maryland, Massachusetts, New Jersey, New York, Rhode Island
General Sales	1932	Mississippi

Sources: Advisory Commission on Intergovernmental Relations. 1994. *Significant Features of Fiscal Federalism, Volume 1*. Washington, D.C.: U.S. government Printing Office. M. Slade Kendrick. 1951. *Public Finances, Principles and Problems*. Cambridge: The Riverside Press.