

GOVERNING

THE STATES AND LOCALITIES

Our Out-of-Whack Tax System

Our economy is increasingly service-based. The way we raise the revenue to support our local governments needs to reflect that.

Today's local governments face what many describe as "permanent fiscal stress," even as the economy rebounds. Many cities and counties have tried to deal with their structural deficits by cutting employee and other costs and/or innovating in service delivery. These are necessary and worthy efforts, and in some cases they have been effective, but neither addresses the ongoing problem: our out-of-whack tax system.

The underlying problem is that the tax system for local governments is not aligned with the economy. Most tax revenues supporting local-government services are generated by economic transactions (for example, the selling of products) as well as taxing property.

Let me give an example of this growing misalignment between public-agency budgets and the economy. If I go to Sears and buy a lawn mower, I pay sales tax, some of which goes to my local governments to support public services. However, I'm not likely to buy a lawn mower; like many people, I hire a gardening service to cut my grass. While the gardening-company owner and its workers typically pay income taxes to the state, the service does not generate any direct revenue for my city or county government.

I live and work in the Silicon Valley in northern California. Our regional economy is largely service- and knowledge-based, activities that do not directly generate tax revenue for local-government services or infrastructure. And, of course, Silicon Valley is hardly alone. By 2011, 80 percent of the national Gross Domestic Product was service-based, and over half of the GDP now results from knowledge-based activity. Less and less of the economy is based on producing and selling "stuff."

We need to broaden the sales tax by extending it to service delivery and knowledge creation. As we do so, we could certainly exempt taxation of some basic services, such as education and health care. By reducing the overall sales tax rate, this effort would initially be revenue-neutral. Over time, however, revenues from taxing services would grow as the economy becomes even more service- and knowledge-based.

I'm not the first, of course, to argue that the tax system that supports local government should evolve along with our economy, and I won't be the last. Our out-of-whack tax system is the political elephant in the room: Few elected officials want to talk about it. It is easier to talk about cutting the cost of government as if that were the only option available to us.

It isn't. We need to act now and reform the tax system supporting local government. Otherwise, we will continue to undercut the public services and infrastructure required for quality community life and a vital economy.

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