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City Competition for Sales Taxes: Symptom of a Larger Problem?

In 1978, Proposition 13 effectively transferred control of the property tax from local governments to the state. Since then, a number of voter initiatives have further constrained the revenue-raising powers of local governments. For this reason, California cities have increasingly sought to augment their revenues through local sales taxes.

Under what is known as the situs rule, a 1 percent locally levied sales tax is collected by the state but returned to the jurisdiction where the sale occurred. Thus, the situs rule gives cities an incentive to promote the location of retail businesses within their boundaries—an incentive that does not exist for residential or industrial development. Although sales taxes are a modest share of total city revenues, cities regard them highly because they represent a major share of their discretionary income—most of the other revenues they receive are earmarked or restricted for specific uses. Moreover, many local policymakers believe that the income they receive from sales taxes has the potential to grow significantly during good economic times—if they encourage retail development.

In their report *California Cities and the Local Sales Tax*, Paul G. Lewis and Elisa Barbour focus on two crucial questions related to cities' strong interest in sales tax revenues. First, what are the effects of the situs-based sales tax on cities' land-use decisions? Second, which types of communities are doing better or worse in the quest for sales tax revenues?

Favoring Retail

Many critics, pointing to local government efforts to recruit retail businesses, have worried about public sector "giveaways" to retailers or developers. Critics also complain that the "fiscalization of land use"—development decisions favoring tax-generating activities—has hampered housing and other non-retail development.

To shed light on this issue, the authors conducted a mail survey of city managers and other top administrative officials in each of the 471 California cities in existence in 1998. The response rate was 70 percent. The survey results provide strong evidence that city governments do favor retail development over other land uses when developing vacant land or pursuing redevelopment. The table below shows how survey respondents rated retail and six other land-use categories on a seven-point scale of desirability. Respondents also indicated that retail projects were the most likely to receive favorable zoning changes or financial incentives (such as a waiver or reduction of development fees). Moreover, they rated the desire for sales tax revenues at the top of a list of motivations guiding development decisions—above such factors as job creation and affordable housing.

Disparities Among Cities' Sales Tax Revenues

In fiscal year 1995–96, per capita sales tax revenues received by California cities ranged from $2.25 to $56,892.

Desirability Score of Various Land Uses for Development and Redevelopment Projects, as Rated by California City Managers on a Scale of 1 to 7

	New Development	Redevelopment
Retail	6.2	6.4
Office	5.6	5.6
Mixed use	5.5	5.6
Light industrial	5.5	5.0
Single-family residential	4.9	3.8
Multifamily residential	3.6	3.8
Heavy industrial	3.5	3.3

SOURCE: PPIC City Manager Survey, 1998.

Retail is the most favored land use for both new development and redevelopment.

A city's success in gaining these revenues can be partly predicted by certain market characteristics. Cities with higher populations, lower densities, fewer people per household, and freeway access tend to have higher per capita sales tax revenues. Cities devoting more of their land to redevelopment projects also do better. However, the relationships between cities' demographic characteristics and sales tax success are not as straightforward. Cities with very low incomes and higher shares of blacks in their populations are less successful, but so are cities with high population growth rates and very high incomes. In the latter case, these "less successful" cities tend to be very wealthy residential suburbs that eschew commercial development. This shows that although the situs rule does systematically favor some cities, it is not necessarily biased in favor of high-status communities.

Fighting over a Finite Resource

In spite of fierce competition for retail business, the hierarchy among cities in terms of their sales tax success has remained relatively stable. Moreover, the total sales tax revenues of all cities, measured in real dollars per capita, were only marginally higher in 1995–96 than in 1971–72. This lack of growth is explained by the relatively fixed nature of retail spending per capita, the many exemptions that state law provides from sales taxation, and the increasing share of consumer spending going to transactions that are not subject to the sales tax (for example, personal services and catalog sales).

Thus, it appears that cities are competing over a relatively fixed amount of per capita revenue. There is only a certain amount of retail activity that can be supported in a region at any given level of population, and cities will not be able to induce "extra" retail development if the additional retailers cannot hope to make a profit.

It is also questionable whether all of the favor cities give to retail business seriously alters retail location. Retailers generally locate in relation to their customer base, transportation accessibility, suppliers, and competitors; and they are likely to locate in certain types of settings, concessions or not. Thus, it appears that the primary effect of cities' preference for retail is a transfer of resources from local government to retailers, developers, and landowners. Given the favorable attention that cities show to retail, it is also likely that residential and industrial development are somewhat more difficult and expensive to develop than would be the case in the absence of a situs-based sales tax.

Rethinking the Problem

The effects of the sales tax on land-use decisions, along with the vast disparities in sales tax revenues among cities, often lead reformers to urge a change in the situs basis for sales tax distribution. One often suggested approach would be to move toward a population-based system for distributing sales tax revenues. This would have several advantages. First, it would reduce some of the extreme disparities in revenues that exist under the current system. Second, it would create an incentive to increase residential population, making housing development more attractive to local governments. Third, it would mean that cities would have less incentive to "chase" retail development, and transfers from government to retailers and developers would be reduced.

However, the population-based approach has disadvantages as well. First, taking funds away from city governments that have managed through entrepreneurial leadership to gain a sales tax advantage seems to punish them for their success. Second, it would increase the tax revenues in wealthy residential enclaves that shun commercial development. Third, the reform would shortchange some cities with very large retail sectors, which often have greater need for public services. Finally, this approach would remove the one major incentive that California cities now have to pursue growth and development.

One might argue that the way toward more balanced development would be to create a local revenue system that provides incentives for other types of growth—not to simply make retail as disfavored as residential and industrial development. In short, scrapping the situs-based system would not solve the broader incentive problems with California's system of local public finance.

Cities often are particularly unenthusiastic about housing because the relatively small share of the property tax they receive is often insufficient to cover the public service costs of homes and apartments. One approach to this problem would be to adjust local finances to make such development less burdensome. Reallocating a substantially greater share of local property taxes to cities and counties—perhaps in exchange for returning other, narrower revenue bases to the state—is one promising approach to this complex problem.

This research brief summarizes a report by Paul G. Lewis and Elisa Barbour, California Cities and the Local Sales Tax. *The report may be ordered by calling (800) 232-5343 [mainland U.S.] or (415) 291-4415 [Canada, Hawaii, overseas]. A copy of the full text is also available on the Internet (www.ppic.org). The PPIC is a private, nonprofit organization dedicated to independent, nonpartisan research on economic, social, and political issues affecting California.*

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