The Government Finance Officers Association

Research Bulletin

Research & Analysis on Current Issues

January 1992

Government Finance Officers Association
Government Finance Research Center
1750 K Street, N.W., Washington, D.C. 20006
(202) 429-2750

Evaluating Alternative Revenue Sources

by Ian J. Allan

Local governments continue to operate in a difficult fiscal environment made worse by the effects of an economic recession. Of increasing concern to many finance officers is the drop in revenues from economically sensitive sources that has led to budget shortfalls and deficits. The financial difficulties encountered by state governments has led to cutbacks in state aid to localities and compounded the problems faced by local governments.

While reductions in spending can be a part of the solution to the fiscal problems of local governments, many have found that expenditure demands have increased during the current recession. As a result of this situation, many local governments are considering the adoption of alternative sources of revenue to bolster sagging collections. This task has been made more difficult by tax revolts in some areas that have made it increasingly problematical for local governments to raise needed revenues through the use of the real property tax.

The purpose of this Research Bulletin is to provide guidance to those finance officers contemplating the adoption of alternative revenue sources and to encourage local governments to develop formal statements of revenue policy. It includes discussion of local government revenue policy and appropriate policy goals, a procedure for identifying tax and other revenue alternatives, a method for evaluating specific tax and user charge alternatives, and the implications of revenue structure reforms for a local government's credit standing. This information can assist finance officers in conducting evaluations of their revenue structure and in providing policy advice to the elected officials who are ultimately responsible for adopting changes.[1]

Evaluating Local Government Revenue Policy

Revenue policy, in its simplest form, represents the set of decisions made regarding the raising of revenues to fund the operations of government, and is reflected in the taxes, fees and user charges imposed within a particular jurisdiction. Many local governments lack a formal, comprehensive statement of revenue policy; their tax and revenue actions are made, instead, on an ad hoc, fragmentary basis.

Ideally, revenue policy will reflect a community's fundamental values, such as the desire to ensure that the living standards of elderly and/or low-income homeowners are not adversely affected by rising residential property values and property tax bills. In reality, state restrictions on local revenue-raising authority prevent revenue policy from fully reflecting these fundamental values. In many states it is not possible to reduce local dependence on the real property tax and, thus, blunt the impact of rising property tax bills, because state governments have restricted the ability of local governments to diversify their revenue structures through the imposition of income or sales taxes.

Why reform the current revenue structure? Reforms are often proposed as a means of defusing a fiscal or political crisis. For example, at the present time an economic slowdown is forcing many local governments to review and revise their existing revenue structures in order to generate sufficient funds to meet growing expenditure demands. Another typical example of reform is where a local government responds to growing complaints about rising property tax bills by attempting to diversify the jurisdiction's revenue base and reduce its dependence on the real property tax. Revenue policies are also reformed because one feature of the tax and revenue system has fallen out of line. For example, the need for and pursuit of revenue adequacy may create inequities in the tax burden that must be addressed at some point in time.

Policy Goals

While opportunities for comprehensive reform of a local government's revenue policy and revenue structure are rare, evaluation of individual revenue sources is quite common. Prior to conducting an evaluation of the local revenue structure, it is important to review what are generally considered to be the appropriate goals of revenue policy. The goals discussed below are not listed in order of importance nor are they mutually exclusive: conflicts and trade-offs between them will be inevitable.

Political Acceptability. Taxpayers expect fairness in the distribution of the tax burden and an understanding of how the burden is allocated. To increase taxpayer understanding of the tax and revenue system, complexity should be kept to a minimum and the assumptions underlying the revenue policy made explicit.

Politically acceptable revenue policies will to a certain extent reflect local tradition and political attitudes. Prior to altering existing revenue policy, a review of the political environment must be conducted. An important component of this review is an examination of existing revenue capacity and revenue effort, including comparisons with other jurisdictions if such data are available. Revenue capacity gauges the ability of a government to raise revenues and is measured in terms of per capita personal income. Revenue effort is a measure of the actual amount of revenue raised by a government, and is often measured in terms of revenue per capita. Evaluating local revenue capacity and effort can reveal citizens' attitudes and preferences towards taxation and the level of taxation that they are willing to bear.

Revenue Adequacy and Stability. The revenue structure should provide the government with sufficient revenues to finance desired public services. Creating an equilibrium between the growth of revenues and the activities that governments finance will be difficult to achieve, but is a worthwhile objective. Ideally, revenue yields, while responsive to income and population shifts, will be dependable and predictable. Economic recessions and changes in state and federal aid distributions can have a negative impact on revenue growth. At the present time, due to the effects of economic recession, revenue adequacy is a major concern of governments at all levels.

Revenue Diversification. An optimal revenue structure includes a balance among the major taxes of property, sales and income; minimizes the use of nuisance taxes; and relies on user charges where feasible. Taxes should be as broadly based as possible to allow for lower tax rates and improve economic efficiency. Diversity in the revenue structure is desirable for political and social reasons.

A diversified property tax base with a balance between the different classes of property is desirable because it will be less vulnerable to economic shifts. To achieve this aim, linkages between tax policy and planning/zoning policy should be forged. In the short term, a balance between the various classes of property will be hard to achieve; in the long term, particularly in growing communities, such balance is a good possibility.

Equity. The distribution of the tax burden and the benefits of public services should be equitable. Horizontal equity requires that the treatment of persons in similar economic circumstances be equal. Vertical equity requires fairness in the distribution of liabilities among persons in different circumstances.

Economic Neutrality. The tax and revenue system should maintain economic neutrality, promoting growth and the efficient allocation of the economy's resources. The goal here is to minimize unintentional interference with private economic decisions in the process of raising needed revenues.

Administrative Feasibility. The complexity and cost of collection of revenues must be considered prior to adoption of a particular tax or revenue source. Compliance should be made simple, certain and inexpensive for the taxpayer, and administration easy and economical for the tax collector.

Self-Sufficiency. To the extent possible it is important not to be overly reliant on federal and state aid so that aid reductions or cutoffs do not interfere with the provision of vital services or distort budget decisions.

Political Feasibility. The use of particular taxes or revenues by state governments may preclude their use at the local level because states may wish to reserve the tax or revenue base for their use alone. Local governments should consider this when evaluating revenue alternatives, and pursue those alternatives which are politically feasible. Legislative advocacy may be required in some cases.

Political Accountability. Increases in local taxes or other revenues should be the product of deliberate legislative action and not inherent structural features of the tax and revenue system that result in automatic rate hikes. A good example is the real property tax and property assessments that have increased from the previous year, resulting in higher property tax bills unless the tax rate is lowered. Some local governments deal with this phenomenon by adopting a truth-in-taxation law that sets a constant property tax yield rate and prohibits increases in property tax levies unless public hearings are held.

Accounting for Tax Exemptions, Abatements and Relief Programs. By tracking and accounting for the value of taxes and other revenues foregone by a local government for the purposes of providing incentives to businesses or for tax relief for low-income property owners, a government can more easily compare its costs with the benefits obtained.[2] A word of caution: it can be difficult to measure the benefits associated with tax abatements and other relief programs, and local governments should be careful not to exaggerate their size.

Exporting the Tax Burden. Tax exportability can be defined as the ability to levy taxes or other revenues in such a way that the burden is borne by taxpayers outside of the jurisdiction of the local government. Exporting the tax burden is a desirable goal because it lessens the burden on a local government's residents. Retail sales and hotel/motel accommodations taxes are generally the most exportable.

Taxes can also be exported to the federal government when local governments take advantage of the deductibility of local property and income taxes from the federal income tax. When searching for revenue alternatives, deductibility (or the lack of it) should be a consideration.

Ordinance Consolidation. To ensure greater control over a government's revenue policy, local laws regarding taxes, fees and user charges should be consolidated. This will enable the local legislative body to review them on a regular basis--easily and comprehensively--and reduces the chance that "old" rates will remain in effect due to administrative neglect.

Other Valid Goals. A local government revenue policy may reflect other goals of the community, such as the preservation of historic properties or provision of property tax relief to homeowners. These goals may conflict with other policy goals, such as the need for revenue adequacy and stability or the desire to maintain economic neutrality.

In the process of examining alternative revenue options, the goals outlined in this section can be used as a means of assessing the feasibility and desirability of the various options as they might be applied in a local jurisdiction. Failure to fully consider these goals could lead to future fiscal and/or economic difficulty, particularly if decisions are made regarding revenue sources that account for a large proportion of the jurisdiction's revenue base. The application of these goals to specific revenue alternatives is more fully discussed in the section on evaluating alternative revenue sources.

Linkage with Fiscal Policy

Revenue policy is inextricably linked with fiscal policy. An evaluation of revenue policy should not be undertaken without an evaluation of expenditure policy. Of particular importance is the identification of the level and mix of services that taxpayers wish to support. Essentially a political decision, this is one of the more difficult challenges facing any government. Nonetheless, only by identifying this "target level of taxation" can reform of the revenue structure be completed successfully. An additional concern is that the revenue structure continue to generate sufficient revenues to meet future spending requirements, while meeting other revenue policy goals.

Linkage with Economic Development Strategy

The revenue policy in place in a local jurisdiction directly affects the business climate and economic development efforts. Policy makers need to understand how the current revenue structure affects the economy and how proposed changes may improve or hinder future economic activity and take into account the interaction between taxation and economic activity when adjusting local tax rates.

Local government policy makers, aware that they are in competition with other jurisdictions for economic development projects, attempt to maintain a healthy business climate in order to discourage businesses from relocating to another jurisdiction and to encourage businesses located elsewhere to relocate in the local jurisdiction. Fear of developing a less competitive tax climate than neighboring jurisdictions has caused many local governments to raise revenues through the imposition of additional user charges and fees rather than by raising major tax rates. This can result in a more balanced tax and revenue system and may ultimately be of greater benefit to a local government's residents and enhance economic development efforts.

Important questions to ask are: Would a tax or other revenue change force a business to leave? Have any businesses complained of heavy tax burdens and financial difficulties? Would tax incentives offered to businesses undermine revenue stability? Would a tax or other revenue change contradict past policies, including the granting of tax abatements to businesses?

Steps in the Identification of Alternative Revenue Sources

Local governments considering the reform of their revenue policies will want to identify alternative revenue sources. The identification of such alternatives can be accomplished systematically through an examination of existing local revenue-raising authority, a review of the experience of other jurisdictions, and an evaluation of the local economy.

Examine Local Revenue-Raising Authority

Local revenue-raising authority varies from state to state depending on a number of factors, including whether the state in which the local government is located allows "home rule" or is governed by what is known as "Dillon's Rule." Local governments granted home rule status are often allowed wide latitude in the selection of taxes and other revenue sources, and only those taxes and revenues specifically prohibited by the state constitution or statutes are unavailable for their use. In Dillon's Rule states only those tax and revenue sources specifically approved by the state for local government use are available to those governments. Currently, forty-one states have granted home rule to their cities, while twenty-eight states have provided home rule to their counties.

Taxes and other revenues that are not currently legal under state constitutional or statutory law would require changes in those laws or the passage of enabling legislation prior to their adoption at the local level. This does not preclude local governments from pursuing such changes, but may make it difficult to adopt certain types of taxes and revenues.

Once the review of the state constitution and statutes has been conducted, the next step is an examination of local law. Two things are important: what revenue-raising authority currently exists; and, what enabling legislation would need to be passed in order to adopt new taxes or other revenues. In most jurisdictions, local ordinances will be necessary in order to adopt new taxes, fees or user charges.

Examine the Experience of Other Jurisdictions

Along with the review of local revenue-raising authority it is usually worthwhile to examine the experience of similar jurisdictions, both within the state and in other states. The revenue-raising experience of other local governments located within state is particularly helpful because the residents of those jurisdictions may have similar attitudes and traditions regarding taxation. This information will be helpful in gauging the feasibility of imposing new taxes or other revenues in a jurisdiction.

The experience of jurisdictions in other states is often the best source of information about potential tax and revenue options. Such a review will not only provide information on tax and other revenue options that are not permitted in your state, but can also provide a sampling of innovative revenue-raising practices in use around the nation.

In evaluating the experience of other jurisdictions, the tax and user charge evaluation criteria discussed in the next section can be utilized. By reviewing the experience of other jurisdictions it will be possible to get a better idea as to what has worked in the past and is likely to work in the future.

Evaluate the Local Economy

Finally, it is important to consider the state of the local economy when evaluating revenue policy. Of particular importance is an examination of relevant economic and demographic trends, including: population, per capita personal income, proportion of AFDC recipients, job trend and workforce, fair market value of real property, and taxable retail sales. Such trend analysis will help to provide the framework for any redesign of revenue policy, can lead to a greater understanding of the environment in which budgetary policy operates, and enable a more practical evaluation of revenue alternatives, including a better understanding of the revenue potential of different options.

While all revenue alternatives may impact or be affected by the local economy, certain alternatives should be evaluated in greater detail. In some instances, the state of the local economy will preclude a local government from imposing certain taxes, fees or user charges. For example, imposing a tax on energy consumption, such as electricity usage, could have a substantial negative impact on an energy-dependent industrial firm that may be experiencing financial difficulty due to the effects of an economic downturn. The loss of jobs and tax revenues due to the closing of such a business could have a devastating effect on a community.

Evaluating Alternative Revenue Sources

A local government's evaluation of alternative revenue sources should involve taxes, fees and user charges. The evaluation of taxes and user charges is slightly different and documented in the following paragraphs. The evaluation of fees can be conducted along these same lines.

Tax Evaluation Criteria

The following criteria can be used in evaluating specific tax options. The criteria provide a means by which each can be measured against the goals of revenue policy; they can also force local government policy makers into explicit choices when selecting one alternative over another. Exhibit 1, on pages 6 and 7, shows how these criteria were applied in an actual analysis of alternative revenue sources conducted by the Government Finance Research Center for Baltimore County, Maryland in 1989.

Economic Efficiency. This criterion is concerned with the possibility that the imposition of a tax or a change in the tax rate or base will result in a change in the relative price of a good or service sold in a jurisdiction and have an effect on private economic choice. A change in relative prices could cause consumers to shop elsewhere for goods and services (the so-called "border city" effect), or cause businesses and individuals to alter their locational choices. If businesses and/or individuals alter their decisions, the tax is said to create efficiency costs.

The price elasticity of demand for a good measures the sensitivity of demand to changes in price. The higher the price elasticity of demand for a good, the more sensitive demand will be to changes in price. The price elasticity of demand for a good is determined by the availability of substitutes. The more substitutes for a good available, the higher will be the price elasticity of demand for that good, thus, that good will be a less likely candidate for taxation. If demand for a good is price inelastic, demand will be unaffected by price, and there will be little need to be concerned about the effect of the imposition of a tax on private economic choice, as there will be little effect.

It is possible to calculate the price elasticity of demand for a wide range of goods, but local governments in the process of evaluating their revenue structures rarely do so. Instead, many governments rely on assumptions regarding price elasticities when making revenue policy decisions. For example, when considering the imposition of a local retail sales tax, local governments often assume that the price elasticity of demand for retail goods is high when there are a number of shopping centers located in adjacent communities that do not impose a local retail sales tax and are viable substitutes for local retailers.

In order to minimize efficiency costs, taxes can be imposed on goods with price-inelastic demand. Efficiency costs are also minimized when broad-based or flat-rate taxes are imposed.

Equity. This criterion is concerned with the effect that a tax change will have on equity between individual taxpayers. The important question to answer is: Who bears the burden of the tax?

One of the basic goals of revenue policy is to design an equitable tax and revenue system. While there has been basic agreement that each taxpayer should contribute his or her "fair share" to the cost of public services, there has been disagreement over what that "fair share" represents. Two approaches have been developed that attempt to deal with this issue. The first approach involves the application of the so-called "benefit principle," while the second approach rests on the "ability to pay" principle.

Applying the benefit principle, an equitable revenue system is considered to be one in which each taxpayer contributes in accordance with the benefits he or she receives from public services. The ability-to-pay principle, on the other hand, requires that taxpayers contribute to the cost of public services in line with their ability to pay. Although the benefit principle is utilized as a justification for the imposition of fees or charges for certain types of public services, such as for the use of recreational facilities, the ability-to-pay principle is widely accepted by economists as the appropriate guide to the determination of equity for revenue policy purposes.

The ability-to-pay approach utilizes two rules in the determination of equity among taxpayers that are important to this analysis. The horizontal equity rule requires that people with equal incomes pay the same amount of taxes, while the vertical equity rule requires that people with greater incomes pay a higher proportion of their incomes as taxes. Generally speaking, the use of a graduated (progressive) rate structure improves vertical equity, while the use of a flat-rate tax structure is better for horizontal equity.

Progressivity, proportionality and regressivity are important equity concepts used in describing the burden of a tax or group of taxes across income levels. Progressivity refers to a situation in which taxes as a proportion of income increase as income increases. Proportionality occurs when taxes as a proportion of income are the same for all individuals. Regressivity refers to the case where taxes as a proportion of income decline as incomes increase.

In evaluating tax equity it is important to determine the effect of a tax on disposable income; i.e., what amount of purchasing power was taken away by the tax? Equity may not be as important an issue if a tax amounts to an insignificant proportion of a low-income taxpayer's total income. Equity will be an issue if a great deal of purchasing power is taken away.

The income elasticity of demand is another important concept that indicates what percentage of marginal income is spent on a good. If the percentage of marginal income spent on a good increases as incomes increase, this is a potential candidate for taxation. Although it is possible to calculate the income elasticity of demand for a wide range of goods, local governments rarely attempt to do so when evaluating revenue alternatives. Rather, many governments rely on assumptions regarding income elasticities when making revenue policy decisions. For example, the federal government taxes luxury items, such as yachts and expensive jewelry, in an effort to exact additional revenues from the wealthiest taxpayers and because these types of goods have a high income elasticity of demand.

Administration. This criterion is concerned with the administrative burden of a tax. Several questions should be answered, including: 1) is the tax easy to evade?; 2) what does the tax cost to administer?; 3) who pays the cost of administering the tax?; and, 4) what is the cost of administration of alternative taxes? The point of this exercise is to ensure the efficient collection of taxes and other revenues. Failure to accurately estimate the burden of administering new taxes or other revenues could lead to situations in which the cost of administering a tax exceeds the cost of alternative taxes or exceeds the revenue collected from the tax.

Determining the cost of administering new taxes may be difficult without detailed study. Information on such costs, particularly for small revenue generators, is almost nonexistent. Generally speaking, broad-based and flat-rate taxes are easier to administer, while taxes with graduated rate structures (such as a progressive income tax) offer incentives for taxpayers to avoid paying.

Political/Legal Considerations. In evaluating the political feasibility of imposing a new tax or increasing a tax rate, it is worth reviewing the findings of the U.S. Advisory Commission on Intergovernmental Relations, which has consistently found that the public's attitudes are generally positive towards the taxation of sales, but negative towards the taxation of income and property.[3] It is also generally accepted that taxes with broad bases and/or graduated rate structures are harder to "sell" to the taxpayer, while taxes with narrow bases and/or flat rates are easier to sell.

As noted earlier, part of the review process involves a determination of the extent to which a local government has state constitutional or statutory authority to impose particular taxes, fees or user charges or increase their rates. In evaluating a specific tax option it is important to determine the legal steps necessary for its imposition.

Once a new tax has been adopted, the possibility exists that legal difficulties related to this option will arise involving such things as conflicting interpretations of statutes or challenges on the grounds of discriminatory taxation. The experience of other jurisdictions in these matters may assist a local government in gauging the likelihood of such a situation occurring.

Yield and Elasticity. This criterion examines the potential revenue yield and elasticity of each tax option. The yield depends on the size of the base and the rate applied. It is important to note that higher yields are often possible at lower rates if a broader base is used.

The elasticity of a tax measures the responsiveness of tax revenue to changes in the underlying base of the tax. For example, the elasticity of an income tax is often measured as the percentage change in income tax revenue divided by the percentage change in personal income. A key question to answer is: will revenues generated by the tax match the growth in expenditures? In order to answer this question it is important to examine the elasticity of the tax and of the expenditure structure. Elastic taxes feature revenue growth greater than growth in the underlying base of the tax, such

Exhibit 1
Alternative Revenue Options for Baltimore County, Maryland

Option	Proposed Revenue Change	Economic Efficiency	Equity Issues	Administrative Effort	Political/ Legal Issues	Projected Yield (FY91)
Ambulance Service Charge	Charge of $50/run	Demand is price inelastic	Benefits-based	Low (third-party collection)	Narrowly-based	$700,000
Increase in Hotel/Motel Occupancy Tax	Increase rate to 10%	Demand price inelastic - exportation possible	Benefits-based/high income elasticity	Low	Narrowly-based	Additional $1,095,000
Expansion of Energy Taxation	Natural Gas: $.01/therm	Demand is price inelastic	Regressive	Low	Broadly-based	$2,360,000
	Electricity (res): 7.5% of value	Demand is price inelastic	Regressive	Low	Broadly-based	$13,407,000
	Fuel Oil: $.02/gallon	Demand is price inelastic	Regressive	Low-moderate	Narrowly-based	$1,471,000
	Coal: $1/ton	Demand is price inelastic	Regressive	Low-moderate	Narrowly-based	1,688,000
Transaction Tax on Automotive Rentals	$2/transaction	Demand is price inelastic	High income elasticity	Moderate-high	Narrowly-based	$370,000+
Boat Mooring Tax	$10/foot of length	Demand probably price inelastic	High income elasticity	Moderate	Narrowly-based	$566,000
Commercial Parking Tax	$10/space	Price inelastic demand	Benefits-based	Low	Narrowly-based; potential legal problem	$428,000
Commercial Rent Tax	2.5% of gross rents	Price elastic - could affect locational decisions		High	Probably legal; businesses opposed	$6.5 million
Motor Vehicle Tax	$25/vehicle	Little effect on number of registrations	Benefits-based	Moderate-high	May be legal; broadly-based	$13.9 million
Bulk Collections Charge	$10/pickup	Price inelastic demand	Benefits-based	Low-moderate	Narrowly-based	$580,000
Title Transfer Tax	Expansion of title transfer tax base	Negligible impact on volume of transactions		Low-moderate	Narrowly-based	$5,700,000

Exhibit 1 (cont'd)
Alternative Revenue Options for Baltimore County, Maryland

Option	Proposed Revenue Change	Economic Efficiency	Equity Issues	Administrative Effort	Political/ Legal Issues	Projected Yield (FY91)
Classification of Recordation Tax Rate Structure	Increase of $.50/$500 for commercial transactions	Negligible impact on volume of transactions		Low	Narrowly-based	Additional $444,000
911 Fees	Increase of $.20/month	Price inelastic demand	Negligible effect on disposable income	Low	Broadly-based; requires state action	Additional $737,000
Motor Fuel Tax	2% of value or $.02/gallon	Negligible effect on consumption	Benefits-based	Moderate	May be legal; less opposition than other major taxes	$5.1 - 7.6 million; $8.5 million
Liquor License Fees	50% increase in fees	Price inelastic demand		Low	Narrowly-based; requires BLC and state approval	$292,000
Classification of Property Tax Rate Structure	Increase of $.25/$100 for Commercial/Industrial properties	Could have adverse effect on business location decisions		Low	Effects business broadly - requires state action	Additional $6.4 million
Local Individual Income Tax	Increase local share to 60% of net state income tax	Could affect locational choices	Would compound regressivity of income tax	Low	Broadly-based - would have opposition - requires state action	$50 million
Local Sales and Use Tax	Imposition of .5% tax	Would alter consumption slightly	Would compound regressivity of sales tax	Low-high	Broadly-based - requires state action	$30.3 million
Local Corporate Income	Imposition of 3.5% tax	Would affect locational decisions		High	Broadly-based on businesses - requires state action	$24 million
Sales tax on Automotive Rentals	Imposition of 2% tax	Price inelastic demand		Moderate-high	Narrowly-based - requires state action	$927,000
Capital Gains Tax on Real Property	Imposition of 1% tax on incremental increase in property values			Moderate-high	Broadly-based; requires state action	Will increase over time

as local personal income or the local economy. On the other hand, revenue growth for income-inelastic taxes increases at the same or a lower rate than that of the underlying tax base. Graduated (progressive) tax rates can increase the elasticity of a tax, while flat rates often result in limited revenue growth.

What is a good tax? Although there are many who would argue that there are no good taxes, public finance economists generally believe that a good tax has some of the following characteristics:

- it is imposed on a good with price-inelastic demand;
- it is imposed on a good with a high income-elasticity of demand;
- it is simple and inexpensive to administer;
- it is acceptable to the vast majority of taxpayers and is beyond legal challenge; and
- its revenue yield grows at a rate that matches or exceeds growth in expenditures.

Evaluating User Charges

When public sector goods or services are similar to those offered by the private sector, the possibility exists that local governments will be able to charge individuals for the use of those goods and services. The ability of local governments to impose user charges for the goods or services that they provide depends on the technical and economic feasibility of the user charge in question. A proposed user charge is technically feasible when the benefits of a good or service accrue to particular individuals and when it is possible to exclude nonpayers from receiving the benefits of that public good or service. User charges are economically feasible when it can be determined that the costs of administering the proposed charges are less than the benefits expected from the substitution of user charges for taxes.

User charges should be set at levels that will allow a local government to recover the costs of providing a service, including: direct labor costs, supervisory and administrative costs, supplies and materials costs, and appropriate indirect costs. By setting user charge rates in such a way, the unintentional subsidization of services with tax revenues can be avoided. In some instances, such as with municipal electric utility charges in several states, charges may be set above cost in order to earn additional revenues for a government. In both cases, state statutes often provide guidance as to appropriate user charge rates.

Local governments considering the imposition of user charges should also note that they are not deductible from federal income taxes, as real property and income taxes are.

Implications of Revenue Structure Reforms for Credit Standing

Reform of a local government's revenue structure could have important implications for its credit standing. Today, the most common reasons why a local government chooses to undertake these reforms is to bolster sagging revenue collections and/or reduce reliance on the real property tax. The most common method used to achieve this is revenue diversification.

Credit analysts generally consider revenue diversification a good thing, up to a certain point. The introduction of income and sales taxes, which can reduce a government's dependence on a single revenue source, such as the real property tax, and add elasticity to the revenue structure, is generally regarded as a positive step. Ideally, a balance between these major revenue sources will be established. Overreliance on a local retail sales tax is not looked upon favorably by credit analysts, however, because its revenues are susceptible to swings in the business cycle.

The real property tax is considered to be the foundation of the local government revenue structure due to its reliability and predictability. Credit analysts view this as a good thing because it indicates that the government has a steady source of revenue to meet its debt service obligations and fund government operations. Reliance on other revenue sources may not provide the stability necessary to conduct the affairs of government in an orderly manner.

Overdiversification could have an adverse impact on a local government's credit standing. Replacing a reliable revenue source, such as the real property tax, with a number of smaller, more volatile revenue sources could be interpreted as an indicator of a weaker fiscal position which could have adverse credit impacts. A well thought out program of implementation that is not viewed as a scrapping of the real property tax probably would not have such impacts.

Endnotes

[1] For those interested in additional information on the evaluation of revenue sources see: Robert L. Bland, *A Revenue Guide for Local Government*, Washington, DC: International City/County Management Association, 1989; and, Robert Berne and Richard Schramm, *The Financial Analysis of Governments*, Englewood Cliffs, NJ: Prentice-Hall, 1986. For additional information on fees and charges, see the forthcoming publication, *Catalog of Fees and Charges*, Chicago, IL: GFOA.

[2] For more information on accounting for tax abatements, see: Edward V. Regan, *Government, Inc.: Creating Accountability for Economic Development Programs*, Chicago, IL: GFOA, 1988.

[3] See: U.S. Advisory Commission on Intergovernmental Relations, *Changing Public Attitudes on Governments and Taxes: 1991*, Report S-20, Washington, DC: U.S. ACIR, 1991.

Ian J. Allan is an Assistant Director with the GFOA's Government Finance Research Center (GFRC). The opinions expressed herein are those of the author and do not necessarily reflect those of the Government Finance Officers Association.

The author would like to thank the following individuals for their comments and suggestions regarding this paper: Barbara Weiss, Cathy Spain, Tom McLoughlin and Dennis Strachota (GFOA); and, Bernard Jump, Jr. (Syracuse University).