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Local Income vs. Sales Taxes: Which Is the Better Source of Local Revenue

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Key Findings

- Local sales and income taxes generate 13 percent and 5 percent of local tax revenue, respectively, making them the two main supplements to property taxes.
- Local income taxes are authorized in 16 states and the District of Columbia. In Kentucky, Maryland, and Ohio, they account for more than 20 percent of local tax collections. Local sales taxes are imposed by 36 states and the District of Columbia. They constitute more than 40 percent of local tax collections in Alabama, Arkansas, Louisiana, and New Mexico. Localities in only seven states, mostly in New England, do not impose either local income taxes or local sales taxes.
- In many states, local income and sales taxes lack uniformity, making the tax system nonneutral and potentially incentivizing residents to make costly or economically inefficient relocation or cross-border shopping decisions. Furthermore, local tax rates for both taxes tend to increase over time, contributing to the overall tax burden in their respective states and benefitting a small subset of wealthy jurisdictions.
- This paper analyzes the current local tax landscape, presents several case studies and recent state-specific trends, and provides several ideas for tax design that states and localities may use to improve their tax competitiveness.
- While sales taxes may generally be less distortive and volatile than income taxes, state and local policymakers need to consider their institutional environment and the tax climates in their neighboring states when choosing between these two taxes.

Introduction

Property taxes remain by far the most important source of local revenue in the United States, generating about 72 percent of local tax collections. However, state and local policymakers are constantly searching for other revenue sources that could potentially reduce the property tax burden and substitute for foregone property tax revenues. Many states have tried two alternatives: local income taxes and local sales taxes. But how do these taxes contribute to overall state and local tax competitiveness? Should one be preferred over the other? Is consumption or income a better tax base for local governments? What are the advantages and disadvantages of both?

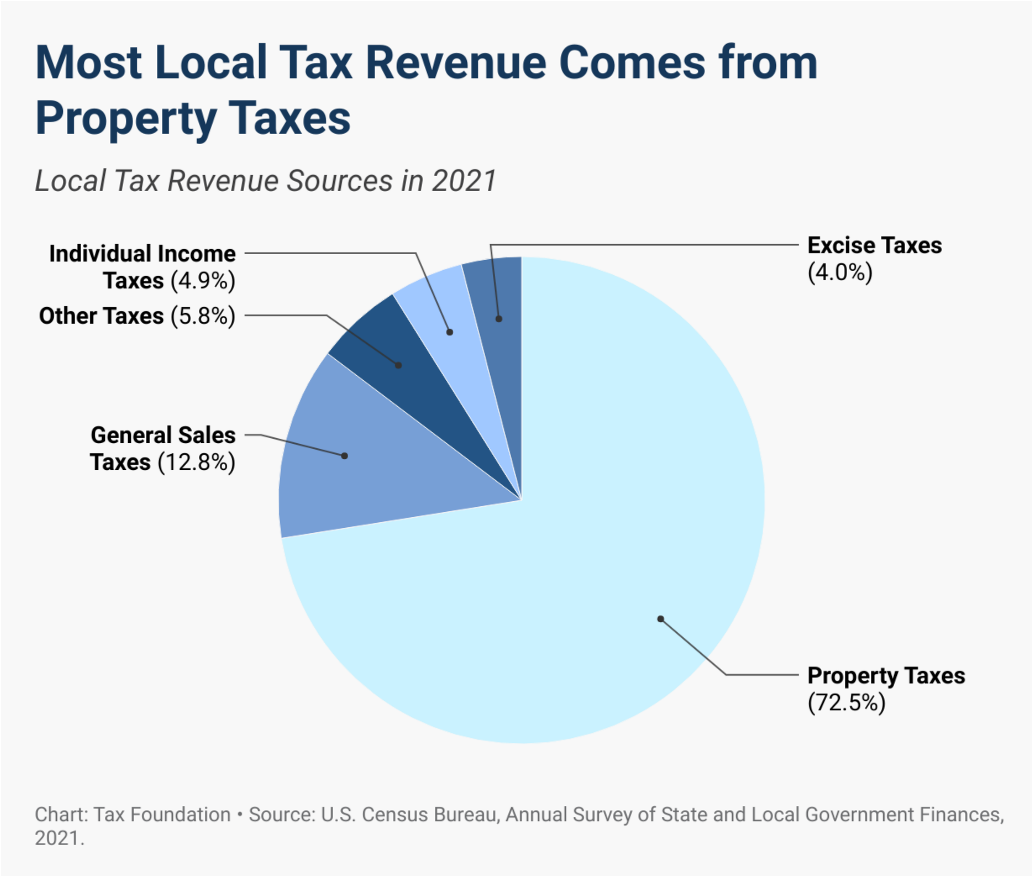
This paper sheds light on the current state of two major revenue sources for local governments in the United States, after property taxes. It provides a descriptive analysis of the most recent local tax data, discusses some limitations of aggregate state-level analyses of local taxes, reviews the theoretical and practical advantages and disadvantages of local income and sales taxes,[1] and presents several tax design ideas for state and local officials considering improvements to and diversification of their tax system. This project complements the Tax Foundation's prior work on local taxes, including annual and topical publications on property taxes,[2] a primer and several state-specific publications on local income taxes,[3] and our semiannual update on state and local sales tax rates,[4] among others.

Local Revenue Sources: An Overview

Local governments in the United States rely on several sources of revenue to ensure the timely and efficient provision of local public services, such as education, roads and transportation, and law enforcement. In 2021, local governments generated almost $2.4 trillion in total revenue, with about $2 trillion in general revenue (excluding utility revenue, insurance trust revenue, and liquor store revenue).[5] Local general revenue sources include tax revenue (42 percent), intergovernmental grants from federal and state governments (37 percent), and charges and miscellaneous revenue (21 percent). Local tax revenue, as shown in Figure 1, is raised through property taxes (72 percent), general sales taxes (13 percent), individual income taxes (5 percent), excise taxes (4 percent), and other taxes (6 percent). The most important source of local tax revenue is the property tax. Experts and academics agree that this is generally a good tax, which theoretically satisfies most principles of sound tax policy.[6] However, much depends on the design and state-specific fiscal rules and institutions.

1 For a detailed overview of the relative merits of local income and sales taxes, see David Brunori, *Local Tax Policy: A Federalist Perspective* (Washington, DC: The Urban Institute Press, 2007).
2 Jared Walczak, "Property Tax Limitation Regimes: A Primer," Tax Foundation, Apr. 23, 2018, https://taxfoundation.org/research/all/state/property-tax-limitation-regimes-primer/; Janelle Fritts, "Close to Home: A Short Guide to Property Taxes," Tax Foundation, Mar. 27, 2023, https://taxfoundation.org/research/all/state/property-taxes-guide/; Andrey Yushkov, "Where Do People Pay the Most in Property Taxes?," Tax Foundation, Sep. 12, 2023, https://taxfoundation.org/data/all/state/property-taxes-by-state-county-2023/.
3 Jared Walczak, Janelle Fritts, and Maxwell James, "Local Income Taxes: A Primer," Tax Foundation, Feb. 23, 2023, https://taxfoundation.org/research/all/state/local-income-taxes-2023/; Andrey Yushkov, "Are Local Income Taxes Compatible with State Tax Reform? Insights from Indiana," Tax Foundation, Dec. 6, 2023, https://taxfoundation.org/blog/indiana-local-income-taxes/; Andrey Yushkov, "Maryland Considers Raising Local Income Taxes," Tax Foundation, Feb. 1, 2024, https://taxfoundation.org/blog/maryland-local-income-tax-reform/.
4 Jared Walczak, "State and Local Sales Tax Rates, 2024," Tax Foundation, Feb. 6, 2024, https://taxfoundation.org/data/all/state/2024-sales-taxes/.
5 U.S. Census Bureau, *Annual Survey of State and Local Government Finances*, https://www.census.gov/programs-surveys/gov-finances/data/datasets.html.
6 Joan Youngman, *A Good Tax: Legal and Policy Issues for the Property Tax in the United States* (Cambridge, MA: Lincoln Institute of Land Policy, 2016).

Figure 1.



Local income taxes, while occupying a modest 5 percent share of total local tax collections, represent a considerably more important source of local revenue in the subset of states that authorize these taxes. Table 1 shows localities' reliance on income taxes as a share of local tax revenue and general revenue. Localities in Maryland depend on income taxes the most: local income taxes constitute 36 percent of local tax collections and 19 percent of local general revenue. Local income taxes are also very important in the Rust Belt states, including Kentucky (26 percent of local tax collections and 10.5 percent of local general revenue), Ohio (21.3 percent and 9.5 percent, respectively), Pennsylvania (18.9 percent and 8.3 percent), New York (14 percent and 7.6 percent), Indiana (12.2 percent and 3.6 percent), Michigan (4.2 percent and 1.3 percent), and Missouri (3.6 percent and 1.7 percent). Some localities in Alabama, Colorado, Delaware, Iowa, Kansas, New Jersey, Oregon, and West Virginia also impose income (payroll) taxes or have fixed-rate wage taxes, but they are much less dependent on them than their counterparts in Maryland or the Rust Belt states. New Jersey represents a particularly interesting case. The state allows two cities to impose a 1 percent tax on gross payroll, but Ordinance 18-33 specifically prohibits employers from "deduct[ing] or withhold[ing] any amount from the remuneration payable to an employee." Despite the prohibition, the ultimate tax burden most likely still falls on employees, not employers.

Table 1. Local Income Tax Collections as a Percentage of Local Tax Collections and Local General Revenue in 2021

State	Local Income Taxes as a Percentage of Local Tax Collections	Local Income Taxes as a Percentage of Local General Revenue
Alabama	1.79%	0.53%
Indiana	12.19%	3.58%
Iowa	1.46%	0.53%
Kansas	0.02%	0.01%
Kentucky	25.95%	10.55%
Maryland	36.12%	19.44%
Michigan	4.17%	1.26%
Missouri	3.60%	1.67%
New York	13.99%	7.58%
Ohio	21.31%	9.49%
Pennsylvania	18.88%	8.29%
District of Columbia	29.72%	15.56%

Note: Flat-rate wage taxes are imposed in Colorado (including Denver), West Virginia (four cities), and Delaware (Wilmington). Oregon imposes local income taxes in the Portland area. These four states, according to the Census Bureau, report zero local income tax revenue but still authorize local income taxes in specific jurisdictions. Kansas has a local intangible tax on interest and dividend income. New Jersey allows Newark and Jersey City to impose a 1 percent tax on gross payroll paid by employers.

Source: U.S. Census Bureau, Annual Survey of State and Local Government Finances, 2021, https://www.census.gov/programs-surveys/gov-finances/data/datasets.html; Tax Foundation calculations.

Sales taxes are levied by localities in 36 states and the District of Columbia. As is the case with local income taxes, local sales tax reliance is not uniform either across or within the states (see Table 2). In Louisiana, sales taxes occupy more than 50.5 percent of local tax collections and 22.4 percent of local general revenue. Localities in other Southern states, including Arkansas (where local sales taxes occupy 49.7 percent of local tax collections and 13.6 percent of local general revenue), Alabama (41.6 percent and 12.3 percent), Oklahoma (39.3 percent and 16.3 percent), Georgia (23.7 percent and 9.6 percent), North Carolina (23.2 percent and 7.2 percent), and Tennessee (21.3 percent and 7.2 percent), also depend considerably on local sales taxes. Other states where local sales taxes are important include New Mexico (41.4 percent of local tax collections and 14.4 percent of local general revenue), Arizona (32.1 percent and 13.1 percent), Colorado (29.1 percent and 14.1 percent), Washington (28.4 percent and 9.6 percent), Missouri (26.4 percent and 12.2 percent), and Utah (23.4 percent and 8.9 percent).

Table 2. Local Sales Tax Collections as a Percentage of Local Tax Collections and Local General Revenue in 2021

State	Local Sales Taxes as a Percentage of Local Tax Collections	Local Sales Taxes as a Percentage of Local General Revenue
Alabama	41.61%	12.29%
Alaska	13.07%	3.88%
Arizona	32.15%	13.10%
Arkansas	49.69%	13.64%
California	15.65%	4.97%
Colorado	29.10%	14.08%
Florida	8.80%	3.53%
Georgia	23.73%	9.61%
Hawaii	10.50%	6.38%
Idaho	0.63%	0.18%
Illinois	5.91%	2.75%
Iowa	6.56%	2.39%
Kansas	17.77%	6.63%
Louisiana	50.55%	22.39%
Minnesota	3.52%	1.06%
Missouri	26.39%	12.19%
Nebraska	8.94%	4.24%
Nevada	16.53%	5.04%
New Mexico	41.37%	14.40%
New York	15.19%	8.23%
North Carolina	23.22%	7.20%
North Dakota	17.44%	5.38%
Ohio	8.95%	3.98%
Oklahoma	39.29%	16.27%
Pennsylvania	2.94%	1.29%
South Carolina	13.12%	5.03%
South Dakota	19.69%	9.67%
Tennessee	21.34%	7.17%
Texas	11.70%	5.73%
Utah	23.37%	8.88%
Vermont	1.98%	0.47%
Virginia	7.61%	3.55%
Washington	28.35%	9.63%
West Virginia	3.09%	1.17%
Wisconsin	4.30%	1.59%
Wyoming	8.11%	1.74%
District of Columbia	13.86%	7.26%

Source: U.S. Census Bureau, Annual Survey of State and Local Government Finances, 2021, https://www.census.gov/programs-surveys/gov-finances/data/datasets.html; Tax Foundation calculations.

Localities in eight states, which include five of the six New England states (Connecticut, Maine, Massachusetts, New Hampshire, and Rhode Island), Mississippi, and Montana do not impose either income or sales taxes. They depend mostly on property taxes, fees and charges, and intergovernmental aid from their state governments. Four states (Indiana, Kentucky, Maryland, and Michigan) authorize local income taxes but no local sales taxes.

Table 3. States Where Localities Do Not Impose Sales or Income Taxes

States with No Local Income or Sales Taxes	States with No Local Sales Tax
Connecticut	Indiana
Maine	Kentucky
Massachusetts	Maryland
Mississippi	Michigan
Montana	
New Hampshire	
Rhode Island	

Source: U.S. Census Bureau, Annual Survey of State and Local Government Finances, 2021, https://www.census.gov/programs-surveys/gov-finances/data/datasets.html.

Local Income Taxes

We have sketched a short history of local income taxes elsewhere,[7] but it is worth noting that the first local income tax in the United States was adopted in Philadelphia in 1939. Other municipalities in Pennsylvania, Ohio, Kentucky, and Missouri followed suit in the 1940s. Michigan, Maryland, and New York followed in the 1960s. Today, 16 states and the District of Columbia authorize various forms of local income taxes.

The share of local income taxes in total local tax collections has been relatively stable over the last three decades. From 1993 to 2007, it was constant at 4.6 percent. From 2007 to 2021, it increased to 4.9 percent.

Local income tax administration varies by state: eight states use the direct collection method (where localities are responsible for collecting, administering, and enforcing local income taxes), four states use the piggyback method (where localities rely on their state's definition of income and state administration and collection of local income taxes), and four states use hybrid methods. Also, some states only authorize counties to impose local income taxes (e.g., Indiana and Maryland), while other states have a complicated system of overlapping income tax jurisdictions, which may include counties, cities, townships, and school districts (e.g., Pennsylvania and Kentucky).[8]

In most states, local income tax rates lack uniformity. Typically, they are higher in larger cities and more urbanized counties and lower in rural areas. Currently, local income tax rates range from 0 percent to 3.75 percent in Pennsylvania, from 0 percent to 3.2 percent in Kentucky, from 0 percent to 3 percent in Ohio, from 0.5 percent to 3 percent in Indiana, and from 2.25 percent to 3.2 percent in Maryland. The highest city income tax rates are observed in Portland, Oregon (a progressive tax with a top rate of 4 percent),[9] New York City (a progressive tax with a top rate of 3.876 percent), Philadelphia (3.75 percent), Baltimore (3.2 percent), Louisville (3.2 percent), and two smaller cities in the Cleveland metropolitan area (3 percent). In some states, only the largest cities are authorized (or choose) to impose local income taxes. For instance, St. Louis and Kansas City are the two cities in Missouri that have a 1 percent local income tax, while Wilmington is the only jurisdiction in Delaware that imposes a 1.25 percent earned income tax.

7 Jared Walczak, Janelle Fritts, and Maxwell James, "Local Income Taxes: A Primer," Tax Foundation, Feb. 23, 2023, https://taxfoundation.org/research/all/state/local-income-taxes-2023/.

8 Ibid.

9 The personal income tax in Portland, Oregon, consists of two components: the Metro Supportive Housing Services Tax (with the rate of up to 3 percent for individuals with taxable income of $250,000 or higher and joint filers with taxable income of $400,000 or higher) and the Multnomah County Preschool for All Tax (with the rate of up to 1 percent for individuals with taxable income of $125,000 or higher and joint filers with taxable income of $200,000 or higher). Additionally, in 2012, Portland implemented the Arts Tax, which has a constant rate of $35 a year.

Advantages of Local Income Taxes

A *broad tax base* is one of the major advantages of local income taxes. While this advantage is clearly important for large cities (where base erosion is unlikely, at least in the short run, due to relatively high wages and numerous job opportunities), it is largely irrelevant for small, rural communities with a limited number of available jobs and poor career prospects. Additionally, with increasing population mobility and ubiquitous remote jobs, the stability of the local income tax base becomes questionable. Still, its broad base generally allows local governments to impose relatively low rates and generate significant revenue.

When states use the piggyback method of tax collection, *administrability and simplicity* become two other advantages of local income taxes. Essentially, taxpayers only need to file a state tax return, and their local income taxes are automatically taken care of. The direct collection method, in contrast, leads to increasing complexities and administrative costs since it is much harder for local governments to audit tax returns and enforce tax compliance, especially in nontrivial cases of nonresident and part-year resident taxation.

Local income taxes, unlike sales taxes, are *highly salient* (residents and nonresidents see paycheck deductions every pay period and likely have all the information about their income tax liability when filing the state and/or local tax return). This makes them more transparent than sales taxes and might increase the accountability of local officials.

Disadvantages of Local Income Taxes

Local income taxes inevitably affect a state's tax competitiveness by *increasing the overall tax burden* for its residents and nonresidents employed in the state. For instance, states like Indiana or Pennsylvania have low and flat state income tax rates (at 3.05 percent and 3.07 percent, respectively), which places them among the most competitive states taxing income. However, as highlighted above, local income tax rates can reach 3 percent in Indiana and 3.75 percent in Pennsylvania, increasing the maximum combined state and local income tax rates in these states to 6.05 percent and 6.82 percent, respectively. As a result, certain areas of Indiana and Pennsylvania have become less attractive for many filers than Georgia, North Carolina, Utah, and West Virginia, not even counting states with no income taxes.

Volatility is a significant problem with income taxes at all levels of government.[10] Generally, local income tax collections are considerably more volatile than property or sales tax collections, especially during economic downturns.[11] When localities rely too much on income taxes, it may raise macroeconomic risks for their states due to the increased need for intergovernmental aid and other economic and fiscal stabilization policies.

The *lack of uniformity* described above is yet another disadvantage of local income taxes, especially in a highly mobile post-pandemic world. At the state level, there is growing evidence that individual income taxes have become an important factor explaining recent interstate migration patterns, particularly regard-

10 Gary C. Cornia and Ray D. Nelson, "State Tax Revenue Growth and Volatility," Regional Economic Development (FRB of St. Louis), 6:1 (2010): 23-58, https://files.stlouisfed.org/files/htdocs/publications/red/2010/01/Cornia.pdf.
11 Jared Walczak, "Income Taxes Are More Volatile Than Sales Taxes During an Economic Contraction," Tax Foundation, Mar. 17, 2020, https://taxfoundation.org/blog/income-taxes-are-more-volatile-than-sales-taxes-during-recession/.

ing the *relocation of high earners*. But the same trend emerges at the local level as well. In Indiana, as we have recently documented, individuals tend to migrate from counties with high and increasing income tax rates to counties with relatively stable or decreasing rates.[12] In the states where overlapping governments (e.g., counties, cities, and school districts) can all impose income taxes, this problem is further exacerbated: moving from one school district to another may considerably reduce a household's income tax liability, which makes this move an attractive (yet nonneutral from the tax perspective) option.

Economic literature provides some evidence that local income taxes may *negatively affect employment*, particularly in large cities and in the long run.[13] For instance, Haughwout and coauthors show that New York City and Philadelphia lost 331,000 and 173,000 jobs, respectively, from 1971 to 2001 due to increases in local income tax rates. Lost jobs may be driven both by outmigration and reduced labor supply (e.g., when individuals decide to retire early or substitute work with leisure when taxes become too high).

Notable Recent Trends

In recent years, many states have dramatically simplified their income tax systems and lowered top marginal income tax rates.[14] This trend has been particularly notable since the end of the pandemic[15] when many states realized that the expected fiscal shock did not materialize, leaving state coffers in a better shape than they were before the health crisis started. However, local income taxes did not follow the same pattern. On the contrary, several states saw considerable increases in average local income tax rates over time.

Figures 2 and 3 demonstrate county-level trends in income tax rates between 2010 and 2024 in two of the states where income taxes are a major source of revenue for local governments, Indiana and Maryland.[16] Both states have a statutory cap for local income tax rates: 3.2 percent in Maryland and 3.75 percent in Indiana. (In Indiana, this encompasses the expenditure rate and the property tax relief rate but does not include the special purpose rate, which may be authorized by the state for specific projects.) In both states, the median local income tax rate slowly but surely converges to this cap, implying that when authorized, local governments tend to fully utilize the fiscal capacity of income taxes in the long run. In Maryland, the median local income tax rate increased from 2.88 percent in 2010 to 3.2 percent in 2024. The number of counties that have a maximum allowed rate increased from 3 to 13. In Indiana, the median local income tax rate increased from 1.33 percent in 2010 to 1.95 percent in 2024. Only 15 counties had a rate above 2 percent in 2010; in 2024, this number has grown to 37 counties.

In Maryland, since most counties are now at the maximum rate, the variation in local income tax rates across counties decreased from 2010 to 2024. In Indiana, it has largely remained the same, but there was noticeable geographical clustering: relatively wealthier counties in central Indiana considerably increased

12 Andrey Yushkov, "Are Local Income Taxes Compatible with State Tax Reform? Insights from Indiana," Tax Foundation, Dec. 6, 2023, https://taxfoundation.org/blog/indiana-local-income-taxes/.

13 Andrew Haughwout, Robert Inman, Steven Craig, and Thomas Luce, "Local Revenue Hills: Evidence from Four U.S. Cities," The Review of Economics and Statistics 86:2 (2004): 570–585, https://doi.org/10.1162/003465304323031120.

14 Jared Walczak and Katherine Loughead, "The State Flat Tax Revolution: Where Things Stand Today," Tax Foundation, Feb. 15, 2024, https://taxfoundation.org/blog/flat-tax-state-income-tax-reform/.

15 Craig L. Johnson, Luis Navarro, Bahawal Shahryar, and Andrey Yushkov, "Long-Term Trends in State Personal Income Tax," Tax Notes State 112:3 (2024): 197-206, https://www.taxnotes.com/tax-notes-state/individual-income-taxation/long-term-trends-state-personal-income-tax/2024/04/15/7jdd2.

16 Indiana and Maryland are particularly transparent with their local income tax data. Other states lack this transparency, sometimes to the point where it is almost impossible to correctly calculate average local tax rates for a given county. This is the case in Kentucky, where county occupational tax data are very accessible due to the efforts of the Kentucky Association of Counties (https://kaco.org/articles/data-brief-2024-county-occupational-tax-rates/), but city data are missing for most of the years. As a result, academic researchers and policy experts struggle to assemble a consistent database of local income tax rates for all the states where these taxes are authorized. This data collection project may represent an important avenue for future research into local income taxes.

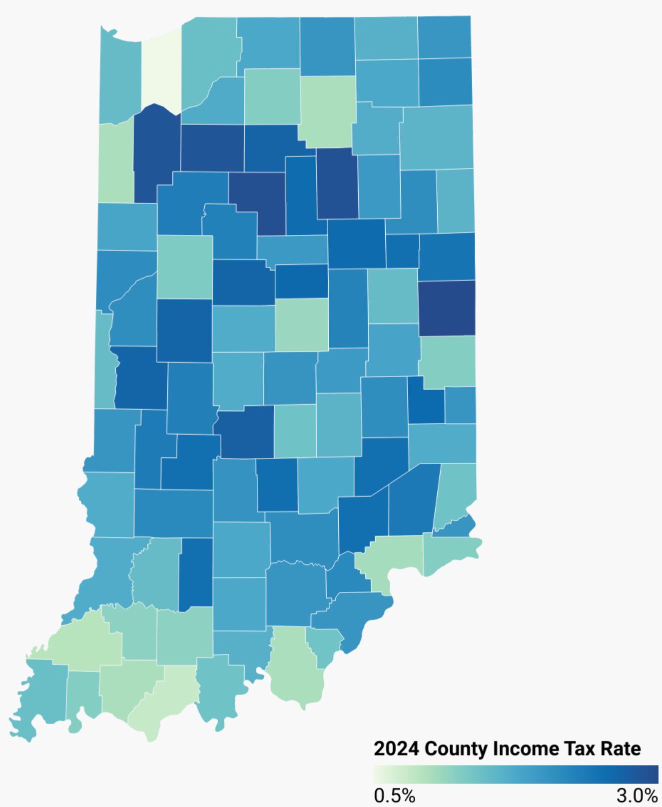
their income tax rates, while counties located on the southern border (with Kentucky, Illinois, and Ohio) did not. An in-depth empirical analysis, which is beyond the scope of this paper, might show whether interstate competition for human capital played a role in constraining local income tax rate growth.

Another notable trend concerns the state and local taxation of nonresidents' income. Since the pandemic and the proliferation of remote jobs, more people have been working in one state and living in another. In such cases, local taxes can be a headache for employees, employers, and tax administrators alike. Recently, in *Zilka v. Tax Review Board, City of Philadelphia*, the Supreme Court of Pennsylvania ruled that only local income taxes (and not combined state and local taxes) paid in a jurisdiction where an individual works may be credited against local income taxes paid in a jurisdiction where an individual lives. In this case, Ms. Zilka lived in Philadelphia and worked in Wilmington, Delaware, and her wages were subject to two state taxes and two local taxes. Ms. Zilka's marginal tax rate in the respective tax years (8.922 percent) was higher than both residents of Philadelphia who work in Philadelphia (6.992 percent) and residents of Wilmington who live in Wilmington (6.25 percent), assuming they all have the same level of income.[17] Since this issue is not unique to the Delaware-Pennsylvania border, many similar cases will arise unless states and localities agree to a common set of rules regarding nonresident taxation (e.g., via tax reciprocity agreements).

Figure 2.

Indiana's Local Tax Rates Have Increased Dramatically since 2010

County Income Tax Rates in Indiana (Percent), 2024



Map: Tax Foundation • Source: Indiana Department of Revenue, "Tax Rates by Indiana County"; Tax Foundation calculations.

17 In the respective tax years, the top income tax rate was 3.922 percent in Philadelphia, 3.07 in Pennsylvania, 1.25 percent in Wilmington, and 5 percent in Delaware. Ms. Zilka's ultimate state and local marginal tax rate was 8.922 percent (3.922% + 3.07% + 1.25% + 5% - 3.07% [credit from Pennsylvania] – 1.25% [credit from Philadelphia]).

Table 4. County Income Tax Rates in Indiana (Percent), 2010 and 2024

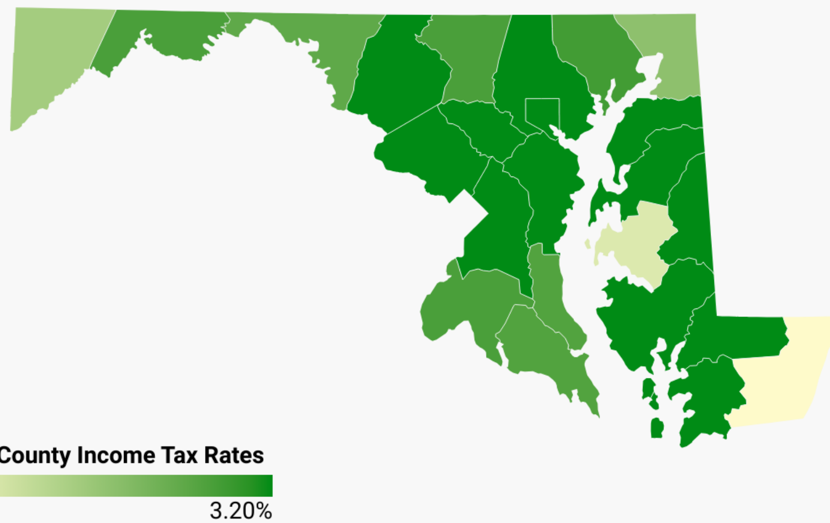
County	2024 Rate	2010 Rate	County	2024 Rate	2010 Rate
Adams	1.60%	1.12%	Lawrence	1.75%	1.75%
Allen	1.59%	1.00%	Madison	2.25%	1.75%
Bartholomew	1.75%	1.25%	Marion	2.02%	1.62%
Benton	1.79%	2.29%	Marshall	1.25%	1.25%
Blackford	2.50%	1.36%	Martin	2.50%	1.00%
Boone	1.70%	1.00%	Miami	2.54%	2.54%
Brown	2.52%	2.20%	Monroe	2.04%	1.05%
Carroll	2.27%	1.55%	Montgomery	2.65%	2.10%
Cass	2.95%	1.75%	Morgan	2.72%	2.72%
Clark	2.00%	2.00%	Newton	1.00%	1.00%
Clay	2.35%	2.25%	Noble	1.75%	1.50%
Clinton	2.65%	2.00%	Ohio	2.00%	1.00%
Crawford	1.65%	1.00%	Orange	1.75%	1.25%
Daviess	1.50%	1.75%	Owen	2.50%	1.30%
Dearborn	1.40%	0.60%	Parke	2.65%	2.30%
Decatur	2.50%	1.33%	Perry	1.40%	1.06%
DeKalb	2.13%	1.50%	Pike	1.20%	0.40%
Delaware	1.50%	1.05%	Porter	0.50%	0.50%
Dubois	1.20%	1.00%	Posey	1.45%	1.00%
Elkhart	2.00%	1.50%	Pulaski	2.85%	3.13%
Fayette	2.57%	2.37%	Putnam	2.30%	1.50%
Floyd	1.39%	1.15%	Randolph	3.00%	1.50%
Fountain	2.10%	1.10%	Ripley	2.38%	1.38%
Franklin	1.70%	1.25%	Rush	2.10%	1.50%
Fulton	2.68%	1.93%	St. Joseph	1.75%	1.75%
Gibson	0.90%	0.50%	Scott	2.16%	1.41%
Grant	2.55%	2.25%	Shelby	1.60%	1.25%
Greene	2.15%	1.00%	Spencer	0.80%	0.80%
Hamilton	1.10%	1.00%	Starke	1.71%	1.06%
Hancock	1.94%	1.26%	Steuben	1.99%	1.79%
Harrison	1.00%	1.00%	Sullivan	1.70%	0.30%
Hendricks	1.70%	1.40%	Switzerland	1.25%	1.00%
Henry	1.80%	1.25%	Tippecanoe	1.28%	1.10%
Howard	1.95%	1.61%	Tipton	2.60%	1.33%
Huntington	1.95%	1.61%	Union	2.00%	1.50%
Jackson	2.10%	1.60%	Vanderburgh	1.25%	1.00%
Jasper	2.86%	3.05%	Vermillion	1.50%	0.10%
Jay	2.45%	2.45%	Vigo	2.00%	1.25%
Jefferson	1.03%	0.35%	Wabash	2.90%	2.90%
Jennings	2.50%	1.25%	Warren	2.12%	2.12%
Johnson	1.40%	1.00%	Warrick	1.00%	0.50%
Knox	1.70%	1.10%	Washington	2.00%	1.50%
Kosciusko	1.00%	1.00%	Wayne	1.25%	1.50%
LaGrange	1.65%	1.40%	Wells	2.10%	2.10%
Lake	1.50%	1.50%	White	2.32%	1.32%
LaPorte	1.45%	0.95%	Whitley	1.68%	1.23%

Sources: Indiana Department of Revenue, https://www.in.gov/dor/i-am-a/business-corp/county-tax-information/; Tax Foundation calculations.

Figure 3.

Local Income Taxes Have Reached Statutory Limit in Most Maryland Counties

County Income Tax Rates in Maryland (Percent), 2024



Map: Tax Foundation • Source: Comptroller of Maryland, "Tax Information for Individual Income Tax"; Tax Foundation calculations.

Table 5. County Income Tax Rates in Maryland (Percent), 2010 and 2024

County	2024 Rate	2010 Rate
Allegany	3.03%	3.05%
Anne Arundel	3.20%	2.56%
Baltimore County	3.20%	2.83%
Baltimore City	3.20%	3.05%
Calvert	3.00%	2.80%
Caroline	3.20%	2.63%
Carrollz	3.03%	3.05%
Cecil	2.75%	2.80%
Charles	3.03%	2.90%
Dorchester	3.20%	2.62%
Frederick	3.20%	2.96%
Garrett	2.65%	2.65%
Harford	3.06%	3.06%
Howard	3.20%	3.20%
Kent	3.20%	2.85%
Montgomery	3.20%	3.20%
Prince George's	3.20%	3.20%
Queen Anne's	3.20%	2.85%
St. Mary's	3.00%	3.00%
Somerset	3.20%	3.15%
Talbot	2.40%	2.25%
Washington	2.95%	2.80%
Wicomico	3.20%	3.10%
Worcester	2.25%	1.25%

Sources: Comptroller of Maryland, https://www.marylandtaxes.gov/individual/income/tax-info/index.php; Tax Foundation calculations.

Ideas for Tax Design

Local income taxes possess innate disadvantages. Most importantly, they are less economically efficient and more distortive at the local level than property or sales taxes. Empirical evidence suggests that individuals reduce their labor supply much more in response to an income tax than to an equivalent consumption tax.[18] To the extent that local income taxes exist, however, a relatively well-designed local income tax should:

- Have a low, flat tax rate and avoid local tax progressivity (which is already being tested in Maryland, New York, and Oregon)[19]
- Use the state definition of income
- Be collected by the state (i.e., a "piggyback" tax)
- Apply uniformly across localities within a given state, or if uniformity is not feasible, leave only a narrow and well-defined range of possible local income tax rates
- Avoid using a designated "property tax relief" rate component, as it is often vaguely defined, is used only by a subset of localities, and may distort real property markets

Local Sales Taxes

Local sales taxes emerged during the Great Depression, virtually the same time as state sales taxes. They were intended to bring much-needed revenue to struggling state and local governments and diversify their revenue structure. Among large metropolitan centers, New York City was one of the first to implement a local sales tax. It was adopted in 1934, one year after New York State imposed its state sales tax. By 1947, the state authorized all counties and cities to administer and collect local sales taxes. Many other states followed New York's example in the subsequent decades, and now localities in 36 states impose local sales taxes.

The share of local sales taxes in total local tax collections has never fallen below 15 percent since the mid-1990s. According to the Annual Census of State and Local Government Finances, it increased from 14.6 percent in 1993 to 16.7 percent in 2007 and has remained at approximately the same level since.

Average local sales tax rates are the highest in Alabama (5.3 percent), Louisiana (5.1 percent), Colorado (4.9 percent), New York (4.5 percent), Oklahoma (4.5 percent), Missouri (4.2 percent), and Georgia (3.4 percent).[20] In the first four of these states, average local rates are higher than state sales tax rates. Also, in all these states, sales taxes are either the first or second most important source of tax revenue for local governments.

As is the case with local income tax rates, local sales tax rates are far from uniform within most states that authorize them. For instance, they range from 0 percent to 8.5 percent in Louisiana, from 1 percent to 8.5 percent in Alabama, from 0 percent to 8.3 percent in Colorado, and from 0.35 percent to 7 percent in Oklahoma. New York and Georgia are among a few states where variation in local sales tax rates is

18 Tomer Blumkin, Bradley J. Ruffle, and Joseph Ganun, "Are Income and Consumption Taxes Ever Really Equivalent? Evidence from a Real-Effort Experiment with Real Goods," *European Economic Review* 56 (2012): 1200-1219, https://doi.org/10.1016/j.euroecorev.2012.06.001.

19 In a seminal paper, Feldstein and Wrobel demonstrated empirically that state and local governments, unlike the federal government, cannot effectively redistribute income through progressive taxation: Martin Feldstein and Marian Vaillant Wrobel, "Can State Taxes Redistribute Income?," *Journal of Public Economics* 68 (1998): 369-396, https://doi.org/10.1016/S0047-2727(98)00015-2.

20 Jared Walczak, "State and Local Sales Tax Rates, 2024," Tax Foundation, Feb. 6, 2024, https://taxfoundation.org/data/all/state/2024-sales-taxes/.

relatively low (ranging from 3 percent to 4.875 percent in New York and from 2 percent to 5 percent in Georgia). This considerable rate variance is exacerbated by the fact that in most states, both counties and municipalities (and, in some cases, districts) are authorized to impose sales taxes and play an equally important role in the local sales tax system. (This group of states includes Alabama, Arizona, Arkansas, Colorado, Illinois, Kansas, Louisiana, Missouri, New York, and Oklahoma.) However, in some states, local sales taxes are levied almost exclusively by counties, as in California, Florida, Georgia, Iowa, Tennessee, and Wyoming. In other states, cities, towns, and townships play a more important role in the local sales tax system, as in Nebraska, New Mexico, North Dakota, and South Dakota.[21]

Advantages of Local Sales Taxes

Local sales taxes, like local income taxes, provide revenue *diversification* to local governments, increasing their *fiscal autonomy* and potentially reducing their dependence on intergovernmental aid from state and federal governments.[22] In counties and cities with growing commercial activity and personal consumption, these taxes satisfy the principle of stability and add to a healthy mix of local revenue sources.

Unlike local income taxes, which typically suffer from double taxation and disincentivize saving and investing, local sales taxes only tax current consumption and *do not distort the intertemporal consumption choices* of individuals and households.[23]

There is mixed evidence in the academic literature regarding whether local sales taxes *provide property tax relief*. In Georgia, while an extra dollar of local sales taxes provided property tax relief of about 28 cents, it was also associated with increased local government spending.[24] Another study showed that differences in local sales taxes across jurisdictions in one state were capitalized into residential property values, making local sales taxes almost equivalent to property taxes in their effects on housing values.[25] If this is the case, adopting a new local sales tax or raising the rate of the existing sales tax to defray property taxes may prove counterproductive, since the overall tax burden is likely to increase over time and capitalization will yield similar burdens to homeownership under the share of tax shifted to sales taxation.

Provided that localities are obligated to use the state's sales tax base and collections are centralized at the state level, local sales taxes satisfy the principles of *simplicity and administrative efficiency*. In this case, the state determines the tax base, collects and administers the tax, and returns local sales tax revenues to the appropriate local governments.

Disadvantages of Local Sales Taxes

A *narrow and shrinking tax base* is a general problem of sales taxes in the United States, affecting both state governments and local governments. When the base is insufficiently broad, both states and localities find

21 David R. Agrawal, "LOST in America: Evidence on Local Sales Taxes from National Panel Data," Regional Science and Urban Economics 49 (2014): 147-163, http://dx.doi.org/10.1016/j.regsciurbeco.2014.09.006.
22 John L. Mikesell, "The Contribution of Local Sales and Income Taxes to Fiscal Autonomy," Lincoln Institute of Land Policy, May 2010, https://www.lincolninst.edu/publications/conference-papers/contribution-local-sales-income-taxes-fiscal-autonomy.
23 This is not the case when localities only tax wage income and do not tax interest, dividends, and capital gains.
24 Changhoon Jung, "Does the Local-Option Sales Tax Provide Property Tax Relief? The Georgia Case," *Public Budgeting and Finance* 21:1 (2001): 73–86, https://doi.org/10.1111/0275-1100.00037.
25 Joyce Y. Man and Michael E. Bell, "The Impact of Local Sales Tax on the Value of Owner-Occupied Housing," *Journal of Urban Economics* 39 (1996): 114-131, https://doi.org/10.1006/juec.1996.0006.

it optimal to increase rates.[26] And as tax rates increase, tax avoidance becomes more appealing to some residents, especially when there is a neighboring state with lower sales tax rates or no sales tax at all.

In a competitive federalist context, the *ease of tax avoidance* is a significant drawback of local sales taxes. Consider the borders of Tennessee and Kentucky, Washington and Oregon, Illinois and Wisconsin, or even certain neighboring counties in Louisiana and Colorado. Combined state and local sales tax rate differentials reach up to 9 percentage points in some of these areas, so it might make economic sense for individuals to cross the border and buy certain goods in a different state, thus violating the principle of neutrality (which occurs when individuals' behavior changes as a result of taxation). Use taxes will not stop consumers from avoiding them, as they are very difficult to enforce, especially when it comes to food, beverages, or smaller household items, and they may not apply where some lesser-rate tax is imposed at the point of sale. Additionally, a recent study found that local sales tax increases, relative to cross-border neighbors, lead to losses of employment, payroll, and hiring, but these effects are limited to counties with substantial levels of cross-border commuting.[27]

As pointed out by David Brunori, *fiscal disparities* represent another drawback of local sales taxes, a critique that is far less relevant to state-level sales taxes.[28] Commercial activity tends to concentrate in a relatively small number of counties and cities. Online shopping may slightly decrease the importance of this problem (as more and more consumers choose large online retailers over shopping malls), yet the variation in local sales tax collections across counties would still likely remain high.

Notable Recent Trends

Like local income taxes, local sales tax rates have, on average, dramatically increased since 2010. Of all 36 states authorizing local sales taxes, only Iowa, Pennsylvania, Florida, and Tennessee have not seen significant spikes in tax rates. According to data assembled by the Tax Foundation, from 2010 to 2024, average local sales tax rates have increased by 31 percent in Alabama (from 4.03 percent to 5.29 percent), 93 percent in California (from 0.83 percent to 1.60 percent), 134 percent in North Dakota (from 0.87 percent to 2.04 percent), and 82 percent in Utah (from 0.63 percent to 1.15 percent). Unlike income taxes, state and local trends were similar in the case of sales tax rates. Since many services, including digital services, and some goods are still tax-exempt in many states, the sales tax base in the United States continues to shrink.[29] This drives both state and local tax rates up and creates larger interstate distortions, incentivizing people to avoid and evade paying these taxes more frequently.

Since the landmark Supreme Court's decision in *South Dakota v. Wayfair*, states have relied upon economic nexus to require remote sellers to collect and remit sales taxes if their sales to the state meet a dollar threshold (frequently $200,000) or a transactions threshold (for instance, 200 transactions) or both.[30] In home rule states, this has had important implications for local governments. Specifically, multiple locali-

26 For a detailed discussion on sales tax rate increases that follow the narrowing of the sales tax base, see John L. Mikesell and Sharon N. Kioko, "The Retail Sales Tax in a New Economy," Municipal Finance Conference Paper, Jul. 16, 2018, https://www.brookings.edu/wp-content/uploads/2018/04/Mikesell-Kioko1.pdf.

27 Shawn M. Rohlin and Jeffrey P. Thompson, "Local Sales Taxes, Employment, and Tax Competition," *Regional Science and Urban Economics* 70 (2018): 373-383, https://doi.org/10.1016/j.regsciurbeco.2017.10.012.

28 David Brunori, *Local Tax Policy: A Federalist Perspective* (Washington, DC: The Urban Institute Press, 2007).

29 See a detailed critique of the existing sales tax system in John L. Mikesell, "Reversing 85 Years of Bad State Retail Sales Tax Policy," State Tax Notes, Feb. 4, 2019, https://www.taxnotes.com/tax-notes-state/sales-and-use-taxation/reversing-85-years-bad-state-retail-sales-tax-policy/2019/02/04/291rj.

30 See more about economic nexus in Manish Bhatt, "Economic Nexus Treatment by State, 2024," Tax Foundation, Mar. 19, 2024, https://taxfoundation.org/data/all/state/economic-nexus-by-state-2024/; and recent empirical evidence on the effects of Wayfair on local governments in Donald Bruce, William F. Fox, and Alannah M. Shute, "Wayfair: A Step Towards the Destination, but Sales Tax Competition Remains," NBER Working Paper 31074, March 2023, https://www.nber.org/papers/w31074.

ties across the nation, including Chicago as well as several local jurisdictions in Colorado and Louisiana, have established local economic nexus requirements.[31] This adds an extra layer of complexity to an already convoluted and inefficient system, especially in the states and localities where nexus requirements are very restrictive. In essence, both remote sellers and local officials face significant costs of compliance and administration, respectively, since the former have to register with every locality and state where they meet a specific threshold (even if they sell 200 chocolate bars in that specific jurisdiction) and the latter have to work with thousands of large and small remote sellers, even if tax revenue generated from most of them is minuscule. Future developments with economic nexus at the local level may have a dramatic impact on the local tax landscape.

Ideas for Tax Design

Local sales taxes are more widespread and less economically harmful than local income taxes. If imposed, an ideal local sales tax should:

- Use the state sales tax base as its base (the state base should ideally be broad and include all final personal consumption while excluding business inputs)
- Have collections and other tax administration functions centralized at the state level
- Exhibit limited rate variability across localities, with the possible exception of certain jurisdictions where the tax burden is easily exported to nonresidents, particularly tourists
- Use sales tax revenues for a broad range of general fund projects instead of earmarking them to a specific, narrowly defined area of the public sector
- Not adopt economic nexus at the local level

Policymakers should also consider ways to address the revenue adequacy problem in small rural areas with limited commercial activity.

Which Is the Better Source of Local Tax Revenue?

Evaluating local tax structure is not simply an exercise of labeling taxes good or bad. Crucially, it involves an analysis of design characteristics—especially when jurisdictional boundaries are easy to cross. Diversifying the local revenue structure may not be a bad idea, particularly considering the popular dissatisfaction with, and some objective concerns about, property taxes (particularly when they are improperly designed). However, local income taxes and local sales taxes have several important disadvantages compared to property taxes. They are generally more volatile (especially income taxes), posing additional risks to local revenue stability during economic shocks. They tend to disproportionately benefit wealthier communities, particularly the largest metropolitan centers, which can afford to increase tax rates without losing too much of their labor force and commercial activity. They are much less neutral than property taxes and may lead to tax avoidance (and sometimes evasion) either in the form of cross-border shopping and smuggling (sales taxes) or through outmigration (income taxes). Additionally (though avoidably), tax revenues generated by these taxes are often earmarked for a very narrow subset of projects, lacking the direct link between taxes paid and benefits received that exists with property taxes.

31 Gail Cole, "Local Economic Nexus Requirements Complicate Remote Sales Tax Compliance," Avalara, Apr. 12, 2022, https://www.avalara.com/blog/en/north-america/2022/04/local-economic-nexus-requirements-complicate-remote-sales-tax-compliance.html.

When local non-property taxes, particularly sales taxes, adhere to the principles of sound tax policy, they can effectively complement property taxes, increasing local fiscal autonomy and reducing dependence on intergovernmental aid. The choice *between* local income taxes and local sales taxes is often in the hands of state governments, so they should approach a potential redesign of their tax system with caution, carefully considering the existing allocation of the overall tax burden among different types of taxes. For example, if the state sales tax rate is already high, it might be unwise to allow counties and cities to impose high and nonuniform local consumption taxes that would negatively affect state tax competitiveness. But if the choice is between local income and local sales taxes, a local option sales tax possesses certain economic advantages.

Local taxation is an essential element of the U.S. tax system and a necessary condition for local government stability and resilience. Its design depends on a state's constitutional and fiscal rules and traditions. However, to stay competitive in an increasingly mobile post-pandemic world, states and localities must learn from the tax policy successes and failures of their neighbors and communities across the nation.