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THE WHITE HOUSE
WASHINGTON

TO:

Jim Fack

FROM:

WARREN HENDRIKS

☒ For your information

☐ Appropriate handling

☐ Letter for Jim's signature

COMMENTS:

AGENDA
FIFTY-FOURTH MEETING
OF THE
ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS
SEPTEMBER 11-12, 1975

1. Remarks by the Chairman
2. Minutes of the Fifty-Third Meeting TAB A
3. Report on State and Local Taxation of Military Personnel TAB B

A hearing on this report, to which spokesmen from the Department of Defense, other military groups, state revenue departments, and other interested parties have been invited is scheduled from 10:00 a.m. to 2:30 p.m. on Thursday, September 11.
4. ACIR Briefing of House Subcommittee on Intergovernmental Relations and Human Resources TAB C

This briefing will be held in the Rayburn Building (room to be announced), at 4:00 p.m. on Thursday, September 11.
5. Report on The Intergovernmental Grant System Study TAB D

Chapter VII - "The 'Target Grant' Experience" was transmitted under separate cover but is a part of Tab D
6. Report on potential National Forest Service grant to ACIR to undertake research on payments in lieu of taxes to counties on national forest lands. TAB E
7. Report on Public Interest Group (Big 7) request that ACIR undertake an assessment of ways to improve the sharing of Federal research and development with State and local governments. TAB F
8. Discussion of plans for ACIR meeting on November 16, 17, and 18 in conjunction with National Municipal League Conference in Chicago



AGENDA (Continued)

9. Report on Implementation Activities
10. Executive Director's Report

TAB G

Thursday, September 11, 1975 9:00 a.m.
Room 2010, New Executive Office Building

Friday, September 12, 1975 9:30 a.m.
Room 2010, New Executive Office Building

A



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

FIFTY-THIRD MEETING
OF THE
ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

Washington, D.C.
April 10-11, 1975

Members Present

Honorable Robert E. Merriam
Honorable John H. Altorfer
Honorable John H. Brewer
Honorable James C. Corman
Honorable L.H. Fountain
Honorable Conrad M. Fowler
Honorable Richard F. Kneip
Honorable Robert P. Knowles
Honorable Charles F. Kurfess
Honorable Richard G. Lugar
Honorable James T. Lynn
Honorable Jack D. Maltester
Honorable Philip W. Noel
Honorable John H. Poelker
Honorable Robert D. Ray

Observers

Lawson E. Becker, American Bankers Assn., Counsel for Michigan
G. Lyle Belsley, Consultant
Ron Blain, Chemical Bank
William R. Brown, Council of State Chambers of Commerce
George D. Bullock, Asst. to Governor Evans, State of Washington
Owen L. Clarke, Deputy Commissioner, Dept. of Corporations and
Taxation, Commonwealth of Massachusetts
William G. Colman, Consultant
Chris Corcoran, Golembe Associates
Daniel M. Crane, Governor's Staff, Rhode Island
William A. Craven, New York State Tax Department
Leighton Cumming, U.S. League of Savings Associations
Bruce Davie, Office of Management and Budget
David Deye, Los Angeles County, California
Lance W. Dickie, Missouri Press Assoc.
Daniel C. Draper, Cadwalader, Wickersham & Taft, New York
William E. Dunn, Commissioner, Salt Lake County, Utah
James B. Eckert, Associate Advisor, Division of Research and
Statistics, Federal Reserve Board
Jane Fenderson, Senate Subcommittee on Intergovernmental Relations
C. Richard Foote, Bankers Trust Company
Delphis C. Goldberg, House Intergovernmental Relations and
Human Resources Subcommittee
Carol Goldfarb, National Association of Counties
Tom Graves, U.S. Railway Association
Thomas Griffin, Governor's Staff, Rhode Island
Douglas R. Guerdat, Office of the Secretary, HEW
Harold Hagen, American Public Welfare Assn.
Peter B. Harkins, Asst. to Mayor Lugar, Indianapolis, Ind.
Saul Heckelman, Acting Commissioner, New York State Department
of Taxation and Finance
W. Gale High, American Bankers Assn, VP and Deputy Comptroller,
The First National Bank of Chicago
Charles Hughes, Office of Management and Budget
Glenn Kumakawa, Governor's Staff, Rhode Island
Richelle Laskins, American Bankers Assn.
Wilbur F. Lavelle, California Franchise Tax Board
James Martin, National Governors' Conference
Mary Ellen McCaffree, State of Washington Dept. of Revenue
Jim J. McCoy, National Savings & Loan League
William F. McKenna, National Savings & Loan League
Richard E. Merritt, National Conference of State Legislatures
Dennis Nagel, Office of the Governor, Iowa
John Norberg, Tax Administrator, Rhode Island
Michel Orban, Office of Congressman James C. Corman
Vince Puritano, Office of Management and Budget
Harold Purnell, Florida Attorney General's Office
William W. Quigg, American Bankers Assn., Vice President and
Trust Officer, The Central Trust Bank, Jefferson City, Mo.
Ronald Rohren, California Bankers Assn.

Observers -- 2

John F. Rolph III, Tax Counsel, American Bankers Assn.
Robert Ruben, Office of Congressman James C. Corman
Henry Ruempler, American Bankers Assn.
Lillian Rymarowicz, Library of Congress
Daniel G. Smith, Wisconsin Dept. of Revenue
William H. Smith, General Counsel, American Bankers Assn.
Paul Sweet, National Conference of State Legislatures
Joseph Taetle, American Bankers Assn.
Vikki Tamoma, American Bankers Assn.
Lois Tanner, Missouri Press Assn.
Dick Thompson, House Government Operations Committee
Richard J. Wall, Chemical Bank
James Whisenand, Assistant Attorney General, State of Florida

Staff Present

Wayne F. Anderson, Executive Director
David B. Walker, Assistant Director
F. John Shannon, Assistant Director
David R. Beam, Intern
John H. Bowman, Senior State Government Resident in Public Finance
Susannah E. Calkins, Research Associate, Bank Tax Study
Lynn D. Ferrell, Intern
Esther Fried, Administrative Officer
L. Richard Gabler, Senior Analyst
Lawrence D. Gilson, Director of Policy Implementation
I.M. Labovitz, Director, Bank Tax Study
Bruce D. McDowell, Senior Analyst
Will S. Myers, Senior Analyst
Albert J. Richter, Senior Analyst
Richard E. Slitor, Assistant Director, Bank Tax Study
Franklin A. Steinko, Jr., Asst. to the Executive Director
Jack P. Suyderhoud, Intern
Francis X. Tippet, Statistician
Michael A. Veseth, Intern
Carol S. Weissert, Information Officer

Minutes of ACIR's 53rd Meeting

Chairman Robert E. Merriam convened the 53rd meeting of the Advisory Commission on Intergovernmental Relations on April 10, 1975.

The Chairman announced the following new appointments to the Commission: John Altorfer, private citizen; U.S. Senator William V. Roth; Congressman James C. Corman; James T. Lynn, Director, Office of Management and Budget; and Governor Philip W. Noel. The Chairman also noted that Mr. Kurfess and Senator Knowles had been reappointed to the Commission.

The Chairman asked for any additions or corrections to the minutes of the 52nd meeting. Mayor Maltester moved adoption of the minutes under Tab A of the docket book. Senator Knowles seconded the motion and it was passed.

Bank Tax Study

The Chairman asked that members consider the proposed report on state and local "doing business" taxes on out-of-state businesses. He noted that the Commission would proceed by holding a hearing on the subject and then would consider the draft staff report under Tab B of the docket book.

Mr. Labovitz, director of the bank tax study, began the hearing phase of the Commission meeting with background remarks and a word of thanks to state tax officials and banking and financial industry representatives who had helped the staff throughout the preparation of the draft report.

The Chairman then called on the individual witnesses representing the states and industry for their comments. The witnesses were as follows:

State tax officials

Wilbur F. Lavelle, Staff Counsel, California State Franchise Tax Board

Saul Heckelman, Acting Commissioner, New York State Department of Taxation and Finance

Owen L. Clarke, Deputy Commissioner, Massachusetts Department of Corporations and Taxation

Mary Ellen McCaffree, Director, Washington State Department of Revenue

Daniel G. Smith, Administrator, Income, Inheritance and Excise Taxes Division, Wisconsin Department of Revenue

Industry representatives

William W. Quigg, Vice President and Trust Officer, The Central Trust Bank, Jefferson City, Missouri

W. Gale High, Vice President and Deputy Comptroller, The First National Bank of Chicago

Lawson E. Becker, Counsel for Michigan Bankers Association, Warner, Norcross & Judd

John F. Rolph, III, Tax Counsel, American Bankers Association

Daniel C. Draper, Attorney for Mutual Savings Banks, Cadwalader, Wickersham & Taft, New York

Representative of the Board of Governors--Federal Reserve System

James B. Eckert, Associate Advisor, Division of Research and Statistics

After all of the witnesses had presented their views and had been questioned by Commission members, the Chairman recessed the meeting for the day.

On April 11, 1975, Chairman Merriam reconvened the 53rd meeting of ACIR. He called on Mr. Anderson to present the draft report. Mr. Anderson suggested that the Commission start its deliberations with a general discussion of the five alternative approaches presented in the staff study. He called on the principal investigator, Mr. Labovitz, to describe the alternatives. Mr. Labovitz reviewed the history of state taxation of depositories and briefly described the alternatives being presented for Commission consideration under the following headings:

- Package A -- No Federal statutory limitations
- Package B -- Negative Federal guidelines
- Package C -- Positive Federal standards
- Package D -- Limitation of taxation to domiciliary states
- Package E -- Federally-collected, state-shared surcharge on depositories
- Special Proposal to Extend Moratorium

Mr. Anderson then read the Congressional mandate to the Commission from the legislation calling for the study. The Chairman suggested that the members might want to proceed by indicating their preferences as to the general package the Commission might recommend.

Mayor Poelker opened the general discussion by noting that Congress requested the Commission to seek an equitable method of state taxation of depositories and that if the states were allowed to pursue their separate courses the likelihood of achieving equity would diminish; therefore his first inclination would be to favor a combination of positive Federal standards (Package C) and limitation of depository taxation to the domiciliary states (Package D).

Senator Knowles noted that ACIR's position on state taxation of other multistate business in 1966 suggested an approach to achieve equity. He rejected the approach of no Federal statutory limitations (Package A) and the approach of a federally-collected, state-shared surcharge on depositories (Alternative E) as nonresponsive either to Federal interests or to state interests, respectively. This, he noted, leaves three approaches, negative Federal guidelines (Package B) and packages C and D. In view of the rapid technological developments in the banking business, Senator Knowles ruled out Package D as an approach that might take care of present circumstances but lacks flexibility to cope with emerging trends. Among the remaining packages, B and C, Senator Knowles expressed the view that it would be difficult to develop positive guidelines on state taxing jurisdiction and on apportionment of income (Package C) and that some points might be missed in the drafting. For

these reasons, Senator Knowles moved that the Commission concentrate its attention on Package B using the "no regular office" and "loan default" provisos. He suggested that a negative guideline on division of base (p. 48 in the docket book) left adequate flexibility for development of further negative guidelines as conditions might warrant.

Commission members then began to explore the implications of recommending the Package B approach. Mayor Poelker asked whether the state purposes to be served were to raise revenue or to regulate the banking industry. Governor Noel asked whether the adoption of any of these approaches makes a difference since banks can't estimate the degree to which there will be interstate branching. Mr. Labovitz acknowledged that rules about branching are essentially state determined, but he noted that below the level of activity associated with branching lies a host of national bank activities now permitted, such as loan production offices and electronic funds transfer systems that can be set up in any state. Thus, the issue becomes whether Congress gives the states freedom to tax such activities and whether the depositories know with some degree of certainty what their tax obligations will be. Governor Noel suggested that ACIR had one other additional alternative, namely a recommendation to continue the existing moratorium on the application of state doing-business taxes to federally-insured banks.

Mayor Lugar observed that costs and dislocations which might be incurred in a search for equity might outweigh the prospects for additional state revenue, and therefore Package D holds most promise because it assures simplicity and certainty in bank taxation and about as much interstate equity as the more complex proposals. Mrs. McCaffree, on behalf of Governor Evans, noted that the Washington (State) Bankers Association opposed Package D and that the Governor favored Package A.

Mayor Maltester asked the staff for its opinion as to which package provides the most equity. Mr. Labovitz responded that it was primarily a question of philosophy. The packages before the Commission ranged from autonomy for the states to certainty of tax burdens for the banks. He noted further that there are considerations other than taxes that influence where banks will attempt to do business. For banks the tax issue is probably secondary to the regulatory problem. It seems likely, therefore, that the amount of state revenue to be directly affected and the tax consequences for the depositories will be relatively small whatever the outcome concerning Federal statutory intervention.

Mr. Anderson pointed out that there may be neither a single nor perfect test for equity, thus the staff could not respond unequivocally to Mayor Maltester's query.

Governor Noel expressed concern about Package D because under electronic funds transfer systems, the individual depositor will largely determine which banks thrive. The Comptroller of the Currency's decision to allow EFTS terminals across state lines may constitute a threat to Rhode Island banks because the state government of Rhode Island can neither tax nor control the out-of-state depository.

Mr. Lynn asked whether, as a procedural matter, it would be possible to suggest that the tax issue be deferred until the matter of regulation of the activities of out-of-state depositories was clarified. Mr. Labovitz noted that the moratorium on state doing-business taxes had not yet cost any state significant amounts of revenue. It does, however, represent a loss of potential revenue for many states since it delays their policy decisions in this field. Governor Noel pointed out that bank holding companies whose nonbanking activities (e.g. leasing) extend across state lines are taxed like other companies in states where such activities constitute physical presence.

The Chairman asked whether anyone favored Package A. Governor Ray and Mrs. McCaffree, on behalf of Governor Evans, supported the Package. Governor Noel also supported the package but indicated a preference for extending the moratorium and for allowing states with out-of-state depositories already doing a full line of banking business to experiment with the "grandfather" cases to see what would work.

Mayor Maltester moved that the Commission proceed along the negative guidelines concept. Senator Knowles supported this concept and noted that P.L. 86-272 employed a similar approach on the jurisdictional side and there were ample options on apportionment and tax base issues. He remarked also that this approach would leave flexibility with states in dealing with EFTS developments but takes care of the cases of California banks in Washington State.

Mayor Poelker said he would opt for positive guidelines (Package C) and would leave for later decision the unknown aspect such as the type of banking activity that will develop from advances in technology. He said that negative guidelines leave too many doors open and fail to give either states or banks much certainty about taxes.

Senator Knowles indicated that he would not object to the positive guideline approach, but considered it unworkable at present; consensus on positive guidelines could not be developed easily; negative guidelines conform to a home-rule-like concept and therefore are more practical. Mr. Kurfess noted that state flexibility in bank tax policy goes with the negative guideline approach. Moreover, he noted that, should changes be required, the negative approach would keep the states from being dependent on Congress for action on guidelines. He further suggested that Congress might be more receptive to the negative guideline approach.

Senator Knowles moved that the Commission adopt the version of Recommendation 1 that would extend the precedent of P.L. 86-272 to the state taxation of out-of-state depositories, immunizing those without a regular office location in the state. Mr. Kurfess suggested and Senator Knowles accepted wording of the recommendation to imply jurisdiction to tax a depository if it met any one of three tests. Mayor Poelker seconded the motion and after further discussion the motion passed with Governor Noel dissenting. The approved recommendation reads as follows:

Recommendation 1.

The Commission recommends that the Congress enact legislation which would deny authority for any State or local government to impose on an out-of-State commercial bank, mutual savings bank, or savings and local association

- a tax on or measured by income or receipts from banking or depository services or property or
- any other tax including a franchise, privilege, general excise, or license tax on or with respect to the conduct of the business of banking or providing other depository services in the State, or based on the value of property, assets, or capital employed in the State

if, during the taxable period, the only business activities or transactions conducted within the State by or on behalf of the bank or association are conducted without a substantial physical presence within the State, in the form of (a) a regular office location, or (b) the regular presence of depository employees or agents, or (c) the ownership or use of tangible property within the State, including property involved in lease-financing operations.

Mayor Poelker moved the adoption of the further proviso immunizing an out-of-state depository from state taxation where it is only seeking to protect its security interest. Mr. Kurfess seconded the motion. The motion passed without dissent and the additional language reads as follows:

Further, the legislation should deny authority to impose a tax if the only activities or transactions conducted within the State by or on behalf of a bank or association are the prosecution of remedies to enforce liens or otherwise protect a security interest in case of default on a loan or other indebtedness secured by property located in the State.

Governor Ray moved that with respect to the division-of-the base question the Commission recommend the "fair share" approach. Governor Noel seconded the motion. The motion passed without dissent and the additional language reads as follows:

The Commission recommends further that such legislation should provide that where a State, in conformity with the foregoing limitations, establishes jurisdiction to impose a tax on or measured by the income, receipts, property, or other "doing business" tax base of a depository institution that has its home office or principal office in another State, the tax may be applied only on a fairly apportioned or attributed part of the entire net income, receipts, property, or other tax base.

The Chairman called for consideration of Recommendation 2 respecting the definition of the income tax base. Governor Noel moved the adoption of the variant recommending that there be no congressional action requiring states to define the tax base. Governor Ray seconded the motion. Comments by several Commission members indicated that such specifics as the definition of the base should be left to state determination. The motion passed without dissent and the recommendation reads as follows:

Recommendation 2.

The Commission recommends that there be no congressional action which would require States to adopt a standardized definition of taxable income in the taxation of out-of-State financial depositories.

Several Commission members raised the question of whether the staff analysis on other issues without further Commission recommendations would be adequate to the needs of Congress. After brief discussion, a consensus developed to complete consideration of the recommendations.

On the motion of Mayor Lugar, seconded by Governor Noel, the Commission rejected a recommendation dealing with apportionment formulas and factors.

Mayor Lugar moved the adoption of the first variant of the recommendation dealing with the inclusion of income from Federal obligations in the tax base of state direct net income taxes. Mayor Maltester seconded the motion. It passed without dissent and the recommendation reads as follows:

Recommendation 3.

The Commission recommends that the Congress amend the Federal public debt statute to authorize States to include, in the measure of otherwise valid direct net income taxes, income realized by financial depositories from Federal Government obligations.

Mayor Lugar moved the adoption of the recommendation to preclude states from discriminating between in-state and out-of-state depositories in their bank tax policies. Governor Noel seconded the motion. It was passed without dissent and the recommendation reads as follows:

Recommendation 4.

The Commission recommends that in legislation regulating taxation of out-of-State financial depositories, the Congress include safeguards against discriminatory taxation by specifying that these depository institutions shall not be subject to heavier taxes than would be imposed if they were domestic corporations chartered or domiciled in the taxing State.

Mayor Lugar moved the adoption of the recommendation regarding the provision of tax credits by the home state for taxes required to be paid to nondomiciliary states. Commissioner Brewer seconded the motion. It passed, with Mr. Kurfess dissenting. The recommendation reads as follows:

Recommendation 5.

The Commission recommends that in legislation regulating "doing business" taxes on out-of-State financial depositories, the Congress should provide that where a depository is subject to such taxation in more than one taxing jurisdiction, the domiciliary State (ordinarily the State of the principal, head-

quarters, or home office) may apply its tax to the entire income (or receipts, capital value, or other tax base) of the business, but shall allow the taxpayer a credit against such tax liability for similar taxes paid to other States (or subdivisions of other States). However, the required credit need not exceed the lesser of (a) the tax or taxes actually paid to nondomiciliary jurisdictions on a portion of the identical or similar tax base, or (b) the tax that would have been payable in the nondomiciliary jurisdiction on an apportioned part of the entire taxable base, as determined under the laws, regulations, and rates of the domiciliary State.

Mr. Kurfess moved the adoption of the recommendation that Congress not specify procedures and mechanisms for adjudicating disagreements between states and taxpayers. Governor Noel seconded the motion. It passed unanimously and the recommendation reads as follows:

Recommendation 6.

The Commission recommends that Federal legislation concerning the application of "doing-business" taxes to out-of-State depositories omit reference to procedures and mechanisms for adjudication of disagreements between States and taxpayers, thus leaving these matters for resolution by customary administrative agencies and procedures established by the States and by applicable judicial proceedings in State and Federal courts.

On a motion by Mayor Maltester, seconded by Mayor Lugar, the Commission rejected a recommendation calling for an arbitration procedure for settling disagreements.

Mayor Maltester moved that the Commission staff be authorized to edit the report, to revise recommendation language to accord with good usage and the Commission's intent as reflected in the discussion and action on recommendations, and to submit the report to Congress. Judge Fowler seconded the motion and it passed without dissent.

Next Meeting of ACIR

The Chairman noted that the staff has a full study agenda of long-term projects. He suggested that the Commission therefore give the staff ample time to prepare for the next meeting. Mr. Kurfess moved that the Chairman be authorized to arrange a time in late August or early September for the next ACIR meeting. Mayor Lugar seconded the motion and it was unanimously adopted.

ACIR Involvement with Public Interest Groups

The Commission members received drafts of proposed policies on appointment of special advisors to ACIR to represent types of governments not directly represented on the Commission and on practices for involving public interest groups, both those represented on the Commission and those not represented, in ACIR research, conference, and other activities. Mayor Lugar moved the adoption of the draft statements as Commission policy. Mr. Kurfess seconded the motion and it passed without dissent.

U.S. Railway Association

Mr. Sullivan and Mr. Graves of the U.S. Railway Association gave Commission members a briefing on the proposed restructuring of the railroad network in the Northeast quadrant.

Report on the NCOAFIA

Mr. Anderson reported that participant reactions strongly evidence that ACIR's National Conference on American Federalism in Action was an outstanding success with wide participation and excellent contributions to current thinking about federalism.

Federal, State, Local Relationships with Indian Tribes

Chairman Merriam called on Mr. Anderson and Mr. Walker to review the staff report on ACIR's involvement in governmental relations with Indian tribes. Mr. Anderson reported the establishment of a new American Indian Policy Review Commission comprised of Federal and Indian tribe representatives whose responsibilities would presumably include state and local relations with Indian tribes. Mr. Anderson noted the staff's conclusion that the ACIR should be more cognizant of Indian affairs as they affect intergovernmental relations but should not initiate a special study of intergovernmental arrangements affecting Indian areas at this time.

Governor Kneip voiced his concern that the new Commission lacks state representation. Mrs. McCaffrey relayed Governor Evans' concern about Indian governments noting that the reservations in Washington State straddle the Interstate Highway system and the Indians have set up stores to sell merchandise free of state taxes to the disadvantage of other retailers. Mrs. McCaffrey agreed with Governor Kneip that state representatives should have an input into the Indian Policy Review Commission.

On the motion of Mayor Poelker, seconded by Judge Fowler, the Commission voted to transmit the staff analysis of November 22, 1974, to the American Indian Policy Review Commission along with an indication of ACIR's (1) interest in the subject, (2) recommendation that the Review Commission's study fully encompass state and local relations with Indian tribes, (3) proposal that state-local advisory members informally be included in the Commission's studies and deliberations, and (4) willingness to help in any appropriate way.

Adjournment

Mayor Poelker moved that the Commission adjourn. Governor Kneip seconded the motion and it passed. Chairman Merriam adjourned the meeting.

B



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

MEMORANDUM

August 13, 1975

To: Members of the Advisory Commission on
Intergovernmental Relations

From: Wayne F. Anderson *WFA*
Executive Director

Subject: Study of State and Local Taxation
of Military Personnel

This study of differential State and local tax treatment of military personnel is an offshoot of a study topic, "Federal, State, Local Tax Coordination," authorized by the Commission at its 47th Meeting. Most of the substantive issues raised by the assignment are being treated in a major fiscal study that analyzes the growth of government expenditures and intergovernmental coordination of tax burdens. It became readily apparent, however, that two specific issues--the military tax question and the interstate enforcement of state cigarette tax laws--should be treated separately. Intergovernmental friction in these areas could be resolved without reference to possible new ways of meshing Federal, State and local tax burdens--involving perhaps the overhaul of the present deductibility system in favor of master circuit-breakers.

The differential tax treatment of military personnel has become a source of intergovernmental friction. At its most recent conference the National Association of Tax Administrators passed resolutions urging Congress to amend the Buck Act so as to make sales by commissaries and PXs subject to state sales and excise taxes. The State tax administrators also urged the withholding of state income taxes from the pay of military personnel.

Because this is a controversial topic, that directly affects several specific groups and interests, it is virtually essential that the Commission hold a public hearing on the staff's findings and conclusions before adopting recommendations and publishing the report. The Pentagon, military retiree groups, state tax administrators, and private business interests have all been invited to send representatives to a hearing on Thursday, September 11, 1975 tentatively scheduled for the hours of 10 A.M. to Noon and 1:30 P.M. to 2:30 P.M.

Contents of the Docket Book Presentation

The study begins by posing the two basic questions:

1. Should the Buck Act be amended to allow State-local taxation of military store sales?

2. Should the Soldiers' and Sailors' Civil Relief Act be amended to end the differential State-local income tax treatment of military persons?

Chapter 2 presents the background material for the Commission's consideration of the first question. It contains an estimate of the amount of State-local sales and excise taxes foregone as a result of the tax exempt status of on-base sales to military personnel. It presents findings under five issues followed by these alternative recommendations: (a) status quo, (b) full State and local cigarette and tobacco taxation, (c) limited State and local taxation of military store sales, and (d) termination of the tax-exempt status of military store sales. (See pages 34 through 47.)

Chapter 3 contains the background and current status of Federal and State laws with respect to the State taxation of military pay. It discusses equity, compliance, administrative and other implications of the present Federally-prescribed State income tax treatment of military pay. It presents alternative recommendations dealing with the jurisdiction of States to tax in accordance with domicile (as is now the case for military personnel) or physical presence (as is now the case with nonresident civilians). (See pages 101 through 121.) Chapter 3 also presents alternative recommendations for Federal changes to facilitate State administration and compliance. The alternatives range from the status quo to far reaching Federal cooperation, i.e., withholding, to assure State collection of taxes on the income of military personnel. (See pages 122 through 143.) There are, in addition, alternative recommendations with respect to State tax law conformity to Federal tax treatment of the income of military personnel. (See pages 144 through 148.)

Previous Commission action on related issues

The Commission in its report Federal-State Coordination of Personal Income Taxes recommended that States conform their income tax laws to the Federal law to ease taxpayer compliance. This previous Commission action has relevance for the last recommendation in Chapter 3. All other recommendations in this study represent new decisions for Commission consideration.

DIFFERENTIAL STATE AND LOCAL TAXATION
OF MILITARY PERSONNEL:
AN INTERGOVERNMENTAL PROBLEM

DIFFERENTIAL STATE AND LOCAL TAXATION
OF MILITARY PERSONNEL:
AN INTERGOVERNMENTAL PROBLEM

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CHAPTER 1:

DIFFERENTIAL STATE AND LOCAL TAXATION OF MILITARY PERSONNEL Scope of the Study

Introduction

This study examines the major issues relating to the differential state and local tax treatment of military personnel. The study, specifically, raises two basic questions:

1. Should the Buck Act be Amended to Allow State-Local Taxation of Military Store Sales? Military stores are Federal entities generally located in areas of exclusive Federal jurisdiction. As such, they are exempt from state-local taxation except as specified by the Congress. The Buck Act extends state-local taxing authority to non-military store sales which take place on military bases, leaving military store sales free of state-local taxation. By amending the Buck Act, Congress could open up military store operations to state-local taxation, either entirely or in part.

2. Should the Soldiers' and Sailors' Civil Relief Act be Amended to End the Differential State-Local Income Tax Treatment of Military Persons? The Soldiers' and Sailors' Civil Relief Act specifies that the military incomes of military personnel may be taxed only by the military person's "state of domicile" while civilian employees are normally taxed by their state of residence. Under another Federal law, state and local income taxes may not be withheld from military paychecks.

Amending the Soldiers' and Sailors' Act could put an end to or alter this differential state-local income tax treatment of military persons.

Intergovernmental Concern

The differential state and local taxation of military personnel is clearly an intergovernmental concern. The military sector is almost solely a Federal responsibility. Military personnel are Federal employees, and commissaries and exchanges are Federally-operated retail outlets. The Federal Government essentially mandates special treatment for these employees and facilities with respect to state and local taxation: in effect mandating a tax cost upon state and local governments because of the existence of a single class of Federal employee (the military) within or near their jurisdictions. This Federally-mandated tax treatment is an intergovernmental problem particularly suited to detailed analysis at this time because:

1. The tax preferences are limited to a particular group;
2. The distribution pattern of the benefits which stem from these preferences is fairly clear;
3. The loss in tax equity as between military and nonmilitary workers is clear and dramatic;

4. The tax losses are significant;
5. An examination of this problem is called for by the substantial alteration of pay and conditions of service for military persons implemented since the adoption of the all-volunteer armed forces concept.

Limited Scope of the Study

The place of the military system in today's society is currently undergoing a broad re-examination. In light of the many changes in military pay, conditions, and status which have accompanied the all-volunteer armed services concept, a number of organizations have elected to study various aspects of military life and recommend changes in them. The Brookings Institution, for example, has recently issued a report, The Military Pay Muddle, which examines the unique way that military people are compensated for their service, and recommends many significant reforms such as the monetization of all military benefits. The General Accounting Office, in a report to Congress issued in the last year, has challenged the basic criteria by which many commissary stores are justified as necessary. The Office of Management and Budget has examined the methods of financing military stores and recommended that the stores become self-supporting. The National Association of

Tax Administrators has passed resolutions urging both the withholding of state taxes from military pay, and the making of exchange and commissary sales subject to state sales and selective excise taxes.

In line with the general re-examination of the military sector, this study deals with the peculiarly intergovernmental aspects of the special state-local tax status of military persons.

Although the basic issues presented here are fairly straightforward, the details are extremely complex. To make the analysis manageable and the recommendations meaningful, the scope of this study is limited in the following ways:

1. The state and local taxes examined here are limited to the sales, excise and income taxes;
2. Federal tax treatment of military income and sales is not treated.

It is important to note that the special military tax status mandated by the Soldiers' and Sailors' Act in non-income tax areas (particularly the personal property tax) is not treated here.

It is tempting to study the special tax status of military incomes and sales in relation to Federal intergovernmental aid programs which are tied to the distribution of

military personnel and bases, such as the Federal impact aid program of payments to school districts which serve dependents of Federally-related employees. In the judgment of the staff this temptation should be resisted. Impact aid payments are, in effect, per-pupil tuition payments made by the Federal Government only to school districts (and not to other types of local governments). These payments are intended to compensate the school districts for the cost of educating students who are the dependents of Federally-related employees who work and/or live on Federal property and who do not make a "normal" contribution to the tax revenues which support the school district due to the tax-exempt status of such property.

Federal impact aid payments were designed to correct a problem which was not uniquely confined to the military population. As I.M. Labovitz described it in his book, Aid for Federally Affected Schools,

"Consigned to a sort of legal no man's land--a zone in which the American tradition of free public schooling for every resident child became entangled with the practical necessity that someone stand ready to pay the heavy and mounting expenses of the schools -- many federally connected families paid special tuition charges in those public schools that would accept their children. Others were forced to seek private schools -- not always available near the workplace to which the parent was assigned.

"Denial of local government services provoked strong discontent especially among those who lived where state and local taxes were collected from them or on federal properties subject to payments in lieu of taxes." (p. 9)

The issue of state and local sales, excise and income taxation of military personnel is entirely separable from these Federal military-related intergovernmental aid programs. These grant monies are intended to correct specific inequities substantially unrelated to the special income, sales and excise tax status of military personnel. Likewise, other Federal intergovernmental aid, grants, and cooperative agreements have been undertaken for specific reasons largely unrelated to the issues raised in this study.

It follows, therefore, that the taxation and equity issues raised herein should stand on their own, and not on their perceived relation to other Federal, state or local taxes, programs, or policies.

CHAPTER 2:

SALES AND EXCISE TAXATION OF
ON BASE SALES TO MILITARY PERSONNEL

Introduction

Throughout much of American history, military outposts were served by private enterprise traders, merchants and camp followers who sought to provide men in uniform with non-issue merchandise at a profit. Unfortunately, some of these traders were less than scrupulous and their profits more than "reasonable". As a result, for many years the Federal government has been operating on-base stores which provide U.S. military personnel with convenient and inexpensive retail outlets. These exchanges, commissaries, and ships stores were originally intended to service military outposts situated far from civilian retail outlets. For a variety of reasons, military stores can now be found on most bases. They provide a wide variety of goods and services to military personnel at a cost usually below that available off-base.

Since post exchanges and other on-base retail outlets are normally located in areas of exclusive Federal jurisdiction (where state and local tax laws do not automatically apply), all sales were shielded from state and local taxes until 1940 when Congress enacted the Buck Act (4 U.S.C. 105-110). This legislation permits the state and local governments to tax certain transactions which take place in Federal areas. For example, if one soldier sells his car to another on a military base, state sales taxes can be levied on the sale. However, the Buck Act specifically does not apply to the sale,

purchase, storage or use of properties sold to "authorized purchasers" by the United States or any of its instrumentalities (e.g., military stores). The Act defines an "authorized purchaser" as a person who is permitted to make purchases from commissaries, ships stores, and post exchanges.

In other words, the legal status of military reservations and the provisions of the Buck Act effectively bar state and local taxation of on-base sales to active duty military personnel, retired military personnel, active duty reservists, the dependents of the above, plus certain other groups including military widows, 100 percent disabled veterans, and members of the Public Health Service and the National Oceanic and Atmospheric Administration. The dollar value of the transactions thus exempted is significant. Table 1 shows the dollar value of untaxed sales on military bases for fiscal year 1973. The total value of these purchases within the United States was over \$4.8 billion in fiscal year 1973--a figure which rose to \$5.6 billion in FY 1974.

The Federal military post exchange system now rates as one of the largest retail sales systems in the United States. As such, its continued exemption from state and local taxes is a legitimate area of intergovernmental concern. In its study of this privilege, the staff has isolated the following key issues:

1. Tax Equity. Tax systems generally attempt to impose similar tax burdens on individuals in

TABLE 1 On-Base Sales to Military Personnel FY 1973

States	Commissary and PX Sales	Tobacco* Sales	Alcoholic Beverage Sales	Total Sales
U.S., TOTAL	\$4,149,083,267	\$307,742,187	\$386,454,877	\$4,843,280,331
Alabama	86,241,254	6,664,837	9,981,013	102,887,104
Alaska	73,800,263	3,025,040	7,011,300	77,520,603
Arizona	74,634,935	2,072,773	5,490,131	82,197,839
Arkansas	27,520,558	2,072,773	2,552,402	32,145,733
California	751,974,997	60,970,306	68,047,238	880,992,541
Colorado	97,811,857	7,296,403	5,283,115	110,391,375
Connecticut	27,559,098	2,225,011	3,533,514	31,317,623
Delaware	13,388,097	1,137,968	1,009,937	15,536,002
D. C.	87,570,501	8,000,000**	7,483,912	103,054,413
Florida	274,012,407	21,838,575	25,532,406	321,383,388
Georgia	155,468,848	12,206,901	11,077,112	178,752,861
Hawaii	164,110,333	6,723,718	19,033,652	189,867,703
Idaho	8,824,044	674,094	749,536	10,247,674
Illinois	91,567,303	7,380,483	7,975,085	106,922,871
Indiana	20,582,732	1,550,519	3,748,425	25,881,676
Iowa	-	-	-	-
Kansas	48,278,844	3,761,084	4,888,542	56,928,470
Kentucky	64,770,359	5,229,715	4,747,425	74,747,499
Louisiana	71,435,647	5,714,485	4,212,800	81,362,932
Maine	20,824,336	1,625,677	2,673,318	25,123,331
Maryland	88,346,203	6,251,918	8,130,806	102,728,927
Massachusetts	74,017,022	5,833,970	10,389,942	90,240,934
Michigan	33,395,472	2,565,617	2,903,806	38,864,895
Minnesota	5,798,149	422,889	1,119,514	7,340,552
Mississippi	51,618,467	4,143,362	4,704,568	60,466,397
Missouri	46,397,464	3,678,486	3,618,288	53,694,238
Montana	11,630,897	892,759	918,041	13,441,697
Nebraska	29,689,804	2,216,393	2,335,226	34,241,533
Nevada	21,485,843	1,671,254	1,509,673	24,666,770
New Hampshire	16,575,987	1,237,429	1,598,229	19,411,645
New Jersey	90,914,036	7,456,827	6,282,088	104,652,951
New Mexico	43,448,578	3,268,877	3,773,333	50,490,788
New York	89,888,069	7,075,221	10,280,159	107,243,449
North Carolina	145,328,168	11,892,901	12,097,052	169,318,121
North Dakota	21,403,221	1,683,091	2,690,254	25,776,566

Ohio	43,946,211	3,260,554	5,910,746	53,117,511
Oklahoma	64,005,735	4,877,454	5,500,969	74,384,153
Oregon	2,283,427	151,289	112,707	2,547,423
Pennsylvania	46,888,302	3,627,076	10,528,876	61,044,254
Rhode Island	40,625,546	3,328,873	6,284,617	50,239,036
South Carolina	122,709,722	9,993,533	11,491,156	144,194,411
South Dakota	11,261,406	866,699	2,411,524	14,539,629
Tennessee	29,994,867	2,494,201	3,200,681	35,689,749
Texas	359,988,538	28,229,988	25,162,289	413,380,815
Utah	17,376,014	1,316,258	2,169,607	20,861,879
Vermont	339,803	20,388	14,452	374,643
Virginia	339,081,777	18,282,958	32,825,804	390,127,539
Washington	126,720,035	9,790,627	12,445,213	148,955,875
West Virginia	-	-	-	-
Wisconsin	5,056,247	472,054	245,454	5,773,755
Wyoming	8,441,844	622,879	768,946	9,833,699

* Includes all Tobacco items.

** Estimates

Source: Military Market Facts Book, 1974.

similar situations. The military tax exemption, to an extent, frustrates this goal of tax equity. Most military employees and their dependents live off-base. Hence they are, in many respects, comparable to their nonmilitary neighbors. Yet, state and local sales and excise taxes can be avoided by the military family making on-base purchases, while the civilian neighbor cannot legally do so.

2. Revenue Loss. The exemption of on-base sales from state and local sales and excise taxation has meant significant losses in potential revenue for sub-national governments. These losses have been increased because lower PX prices have diverted retail business from off-base outlets (where state and local taxes apply) to nontaxable on-base stores.
3. Problems of Interaction with Local Economies. The tax exemption of on-base sales, combined with the normally lower prices of military stores, draws business from the local private sector.
4. Bootlegging. Because military store goods often sell for less, some individuals have been involved in bootlegging of these goods for resale off-base.



This has particularly been true for tobacco products, where state and local tobacco taxes can make a difference of \$2.00 or more between the on-base and off-base price of a carton of cigarettes. This bootlegging has contributed to tax loss and created some law enforcement headaches.

ISSUES AND FINDINGS

The Changing Rationale for Differential Taxation

Changes both in the extent and scope of both on-base retail operations and state and local sales and excise taxation have altered the rationale for the exemption of military store sales from state and local sales and excise taxation--a fact that has not been explicitly considered by any legislative body. This development, therefore, must be weighed alongside another fact--that the right of military persons (including active duty and retired military personnel and their dependents, disabled veterans, active duty reservists and Medal of Honor winners) to make commissary and post exchange (PX) purchases free of all state and local sales and excise taxes is a tangible benefit long held and rightly valued by these groups.

In the beginning, commissaries and PXs were built solely for the use of those military persons stationed far from civilian retail outlets. As a chairman of a subcommittee of the House Armed Services Committee said in 1949,

"The whole theory of the commissary privilege ... was originally to give it to the people who were at isolated stations who did not have the benefit of metropolitan sales. That is the whole theory and the only justification for it. It was never intended that the Government would go in the business of providing for its personnel where they have the privilege and opportunity to go to a private place to buy. It was intended on account of the remoteness of stations to accommodate them."^{1/}

This is not the case now, however. In fiscal year 1973, there were a total of 267 commissary stores and 476 PXs located on the 430 military installations located in the continental United States. Many of these installations and stores are located in or near metropolitan areas and do not qualify as "isolated stations." Indeed, a General Accounting Office study of the justification of commissary stores found that there were a total of 27 commissaries located in the six cities they sampled.^{2/} None of these bases was "isolated"--all were virtually surrounded by civilian retail food stores--yet each operated a commissary.

When military store operations were first begun, most military persons lived on-base, so the commissary and PX stores were the rough equivalent of the civilian neighborhood store. Now, however, over two-thirds of married military

personnel are living off the military reservations, and a sizable portion of single military people are choosing to live off-base as well. These people often have to make special trips in order to shop at the base military store. The role of the military store for these people has obviously changed.

At the same time these basic changes in the military lifestyle were taking place, military incomes were also rising, making military persons better able to bear the burden of state and local taxes. As recently as 1963, a military recruit earned only \$78 per month basic pay. This pay level has now increased to over \$340 per month. Other, higher paid, military ranks have experienced pay increases ranging from 76 to 351 percent since 1963. Current military pay scales are shown in Appendix B.

As these and other changes in the military lifestyle were taking place, the military store system grew (although it has declined somewhat in the post-Vietnam years). From a modest start, the commissary and PX system has grown to the point that, in FY 1974, these stores accounted for \$5.6 billion dollars in retail sales.

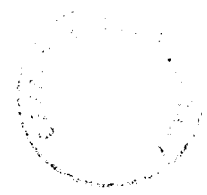
While these changes have been taking place in the military store system, state tax systems have been changing as well. As recently as 1954, only 34 states had general sales

taxes. The median rate was only two percent and the highest rate was a modest three percent. By 1973, however, the number of states collecting a general sales tax had increased to 46 and the median rate had jumped to four percent, and the maximum rate to seven percent. On the excise tax front, all 50 states plus the District of Columbia currently impose cigarette and alcoholic beverages taxes, and the trend here, as well, has been one of steadily rising tax rates.

The result of all of these changes is that, as the U.S. Government has grown from a small distributor of goods in isolated outposts to a major operator of retail outlets, the exemption of on-base sales from state and local sales and excise taxation has gone from a convenience factor of small fiscal consequence to a military economic fringe benefit of significant value. This change has occurred gradually over the years and was not explicitly legislated. When the Congress last addressed the taxation of the sales of on-base retail outlets (at the time the Buck Act was passed in 1940), the tax exemption benefit was small both for individuals and in the aggregate, although the potential for growth was clear.

Tax Equity

The exemption of on-base sales to military persons from state and local sales and excise taxation raises serious tax equity issues when measured against both the ability to pay and benefits received criteria.



The notion of taxation according to ability to pay normally calls for people of similar means (similar incomes or wealth) to bear similar tax burdens. This is clearly not the case when one class of citizen (military people) can legally avoid payment of most state and local sales and excise taxes by purchasing desired items (to the extent that they are available) through on-base retail outlets. The tax burden on the military person is lighter than it would be on a comparable civilian (one with comparable income or wealth) by a factor directly proportionate to the amount of goods which he purchases through the commissary and PX system.

Similarly, the principle of taxation according to benefits received requires individuals who consume similar amounts of public services to bear similar tax burdens. This tenet is violated in the case of military persons who live off-base, consuming roughly the same state and local public services as their neighbors, but who make a smaller contribution to the financing of these services because they are able to avoid the payment of sales and excise taxes through on-base purchasing.

Although the tax exemption privilege undercuts these tax equity criteria, certain additional factors must be taken into account before it is possible to make any final judgment on the tax equity issue. For one, it should be noted that most

military persons pay at least some state and local taxes--not all such taxes are avoided. They pay normal state-local taxes on all purchases made off the military reservations and on non-military purchases made on the reservations (as per the provisions of the Buck Act), and those who live off-base pay real property taxes.

Second, it should be noted that military persons, especially those who live on the military base, may not make exactly the same use of state-local public services as 'normal' civilians would. The standard of taxation according to benefits received would suggest that these families should bear a somewhat lighter burden than their civilian counterparts. Taxation according to ability to pay, however, would dictate equal tax burdens.

Finally, there is the contention, expressed by many military spokesmen, that military persons are not comparable to civilians for taxation purposes. Military personnel have less control over their lives than do civilians. They may not 'quit' their jobs when dissatisfied, but may terminate service only when their duty term has lapsed. Their jobs may involve loss of life or debilitating injury. These and other differences, it is noted, make the military person, the compensation he receives and the taxes he pays, non-comparable to civilian workers. This argument is not directly applicable to certain groups which now share the tax-exempt military store privilege such as military retirees who live in the civilian community and generally have no further armed forces obligations.

There is no objective way to evaluate the argument that military people are not comparable to civilians. This question appears to be a matter of personal judgement on which people of good faith may reasonably disagree. However, the two basic principles of tax equity suggest that many military persons bear a lighter state and local tax burden than they should due to the exemption of military store sales from state and local sales and excise taxation.

State and Local Tax Subsidies

The exemption of on-base sales to military personnel from state and local sales and excise taxation imposes an implicit burden on state and local governments. The losses of potential revenues that these governments must bear may be viewed as a tax subsidy to military people, mandated by the Federal government, but borne by state and local governments.

The constitutionality of the present state-local tax exemption as it applies to federally-operated military stores is clear. However, since the U.S. Government does not choose to operate tax-free retail stores for the use of the general public, it must be assumed that the tax exemption as it applies here is intended to be an economic benefit accruing to Federal military employees and related groups. This economic subsidy could be financed by the Federal government in

the form of higher levels of direct military compensation. Instead, by making use of the Constitutional prohibition against state or local taxation of a Federal entity, the national government has effectively passed on the cost of this benefit to the state and local governments.^{3/}

The approximate size of this benefit is shown by Table 2. This table shows the amount of state sales and cigarette excise taxes which would have been paid on the turnover of military stores in each state had military store sales been taxable in FY 1973. As such, these figures represent the cost of the military tax-exemption benefit to each state. The estimated total cost of the sales tax benefit is set at over \$135 million and tobacco tax benefits amounted to \$130 million. In addition, over \$350 million worth of alcoholic beverages were sold free of state taxes through military stores, resulting in an estimated \$30 - \$40 million additional revenue loss to the states.

The size of the state-local subsidy may not be large on a national scale--probably somewhat less than \$400 million total (Table 2 figures do not include local tax benefits, or additional sales taxes which would be paid on tobacco if tobacco taxes were imposed). However, the burden of the military tax subsidy is significant in states which have a military

presence. California's tax subsidy is estimated at more than \$49 million for the sales and tobacco excise taxes alone. This figure is estimated at over \$21 million for Florida, \$30 million for Texas, and more than \$10 million each for Georgia, Virginia and Washington.

TABLE 2 ESTIMATED POTENTIAL TAX LOSSES DUE TO EXCLUSION
OF ON-BASE SALES FROM STATE SALES AND EXCISE
TAXATION--FY 1973

States	Retail Sales Tax Loss <u>1/</u> (\$1,000)	Tobacco Tax Loss <u>2/</u> (\$1,000)	Combined Tobacco and Sales Tax Loss <u>3/</u> (\$1,000)
U.S., Total	135,955	130,242	266,197
Alabama	3,450	3,949	7,399
Alaska	-	896	896
Arizona	2,238	768	3,006
Arkansas	826	1,363	2,189
California	26,507	22,583	49,090
Colorado	2,934	2,703	5,637
Connecticut	1,343	1,731	3,074
Delaware	-	590	590
D.C.	3,722	1,778	5,500
Florida	8,220	13,751	21,971
Georgia	4,664	5,425	10,089
Hawaii	6,564	1,993	8,557
Idaho	265	227	492
Illinois	3,663	3,281	6,944
Indiana	617	344	961
Iowa	-	-	-
Kansas	1,448	1,533	2,981
Kentucky	2,429	582	3,011
Louisiana	1,964	2,328	4,292
Maine	781	843	1,624
Maryland	2,650	1,389	4,039
Massachusetts	1,663	3,458	5,121
Michigan	1,336	1,045	2,381
Minnesota	174	282	456
Mississippi	2,581	1,688	4,269
Missouri	1,392	1,226	2,618
Montana	-	397	397
Nebraska	742	1,068	1,810
Nevada	430	619	1,049
New Hampshire	-	504	504

New Jersey	3,409	5,248	8,657
New Mexico	1,738	1,453	3,191
New York	2,697	3,931	6,628
North			
Carolina	4,360	881	5,241
North			
Dakota	642	686	1,328
Ohio	1,318	1,811	3,129
Oklahoma	1,280	2,348	3,628
Oregon	-	50	50
Pennsylvania	2,110	2,418	4,528
Rhode Island	1,523	1,603	3,126
South			
Carolina	4,908	2,221	7,129
South			
Dakota	450	385	835
Tennessee	1,050	1,201	2,251
Texas	10,800	19,344	30,144
Utah	695	390	1,085
Vermont	8	9	17
Virginia	10,172	1,693	11,865
Washington	5,702	5,802	11,504
West			
Virginia	-	-	-
Wisconsin	152	280	432
Wyoming	338	184	522

-
- 1/ State sales tax figures only--excludes local sales tax losses.
In states where food is untaxed or taxed at a different rate,
25 percent of sales were assumed to fall into this category.
Tax rates used are those applicable as of July 1, 1973.
 - 2/ State tobacco taxes only--excludes local sales tax losses.
Tax rates used are those applicable as of July 1, 1973.
 - 3/ Does not include additional sales tax loss on higher tobacco
prices if state tobacco taxes were imposed.

Source: ACIR staff computations; Table 1.

Effect on Local Businesses

Without question, the presence of a military base in an area is a stimulus to the local economy and is beneficial to local merchants. However, the exemption of military stores from state and local taxation, to the extent that it lowers already low military store prices, tends to disturb trade patterns as business which would otherwise go to civilian merchants is drawn to the military outlets.

That military stores provide significant competition to civilian retail merchants can be shown in a number of ways. As Tables 3 and 4 indicate, the military store systems are very large.

U.S. military commissary stores achieved over \$2.1 billion dollars in sales in 1974--ranking ninth among U.S. food chains. The PX system achieved \$2.4 billion in sales to rank seventh among department store chains. These figures tend to underestimate military sales volume, however. Department of Defense directives require that commissary and PX prices must average 20 percent below comparable civilian retail prices. It follows that the actual volume of goods sold through military stores is somewhat higher than sales figures would indicate.

Many military stores gross much more than the \$4.3 million store average. The military store operation in Fort Myer,

Virginia, for example, takes in over \$15 million annually.

Being large stores selling at significantly lower overall prices, the military stores enjoy a natural advantage, in many ways, over civilian retail outlets. The state and local tax exemption of their sales adds to this advantage. The effect of this total advantage is to divert retail sales by military persons, retirees living in the community, and others, from civilian to military retail outlets. To the extent that the state and local tax exemption adds to the attractiveness of military store purchases, it adds to the disturbance of local retail sales patterns.

TABLE 3: SALES VOLUME OF MILITARY COMMISSSSRY SYSTEM
VERSUS TOP NINE FOOD STORE CHAINS

Rank	Store Chain	1974 Sales (\$ Billion)
1	Safeway	8.2
2	A & P	7.0 (e)
3	Kroger	4.8
4	American Stores	2.8 (e)
5	Lucky	2.7
6	Jewel	2.6 (e)
7	Winn-Dixie	2.5
8	Food Fair	2.4
9	U.S. Military Commissaries	2.1
10	Grand Union	1.6 (e)

(e) Estimated

Source: Progressive Grocer, April 1975 and Department of Defense.

TABLE 4: SALES VOLUME OF MILITARY EXCHANGE SYSTEM VERSUS
TOP SEVEN DEPARTMENT/VARIETY STORE CHAINS

Rank	Store Chain	1974 Sales (\$ Billion)
1	Sears Roebuck	13.1
2	J. C. Penney	6.9
3	Kresge	5.5
4	F. W. Woolworth	4.1
5	Federated	3.5
6	Rapid American	2.8
7	Military Exchanges	2.4
8	W. T. Grant	1.8

Source: Standard & Poor's and Department of Defense

Tobacco Taxes -- Bootlegging for Off-Base Sales

State tax officials, military officials, and others have become concerned with the bootlegging of cheaper, tax-free military store items for resale off the military base. This concern has centered around cigarettes. State and local cigarette taxes can amount to over \$2.00 per carton. As a result, military store cigarettes have a significant price advantage over off-base cigarettes in most states. This price differential due to the military tax exemption, combined with the easy transportation, of and ready market for, tax-free cigarettes, has apparently lead to bootlegging activities among some military store patrons.

It would be unfair to characterize most military persons as "cigarette runners." Yet it is widely believed that many military people have, by being "good neighbors" and sharing their tax-exemption with friends and relatives, abused their special tax status. Some military individuals have also used the tax differential to earn extra money by illegally selling military store cigarettes at a profit.

The military is well aware of the potential for this bootlegging, and has taken steps to inform military store patrons of the illegality of such actions. If caught bootlegging commissary or PX merchandise, a military person can

lose his military store privilege or suffer more serious punishment. In addition, in order to make bootlegging of cigarettes less likely, several base commanders have instituted daily, weekly and/or monthly purchase limits (generally limiting sales to 15 cartons per month, although more stringent limitations exist as well). In general, the military has expressed a willingness to cooperate with state and local officials to halt bootlegging of cigarettes and other military store items (including liquor, etc).

Despite these efforts, it appears that military store cigarette bootlegging--whether for profit or for a less selfish motive--is still a problem.

Because cases of military store bootlegging seldom involve large organized operations (more often taking the form of the military person or retiree bringing home an extra carton for the guy next door), it is virtually impossible and expensive, relative to the tax amounts involved, to enforce state laws in this area. Therefore, there is little hard data available to indicate the extent of bootlegging currently taking place. However, comparisons of per capita purchases among military patron populations and civilian store patron populations can give some indication of the extent of the problem. Table 6 provides this comparison.

As Table 6 indicates, there are significantly higher sales to military store patrons than to civilian store patrons in states having high cigarette taxes. For example, in Washington State, with a 16 cent per pack cigarette tax, cigarette sales among the civilian store patron population 18 years and over averaged 144 packages per year per person in fiscal 1973. For the military store patron population this average was 247 packages per year. Likewise, in Texas (with an 18 1/2 cent cigarette tax), the estimates indicate a 171 pack per capita civilian sales and a 233 pack per capita sale to the military population. The corresponding numbers for Connecticut (21 cent tax) are 163 packages for the civilian population, and 193 for the military store patron population.

These higher sales among military store patrons seem directly linked to the high cigarette taxes found in these states. Virginia, with a low 2 1/2 cent cigarette tax, actually showed a lower sales average among military than civilian store patrons--indicating, perhaps, that low cigarette taxes diminish the incentive to purchase tax-free cigarettes, or limit their marketability. This phenomenon is seen even more dramatically in North Carolina (with the lowest state cigarette tax in the U.S.--where civilian cigarette purchases is estimated to be over 50 percent greater than military per capita

sales. Part of the higher civilian per capita purchases may be attributed to civilian cigarette bootlegging activities between low-tax North Carolina and Virginia and the relatively high cigarette tax states of the Northeast (this civilian cigarette bootlegging problem is the topic of another ACIR staff study currently in progress).

The Department of Defense has released figures indicating that military store per capita cigarette sales average only 40 percent of civilian per capita sales. Staff has examined this figure and concludes that the Defense Department estimate is faulty because it includes in its population base all persons eligible to shop at military stores, whether they do so or not.^{4/} This produces an overly large base over which to divide total military store cigarette sales. It is more relevant to estimate per capita consumption on the basis of the population which actually benefits from store sales. More importantly the Department of Defense study looked only at military exchange cigarette sales. Both exchanges and commissaries sell cigarettes on-base, however, exchange sales account for a relatively small part of military cigarette sales because exchange cigarette prices normally are higher than cigarette prices in the commissaries. It is not surprising, then that per capita sales calculated on the basis of exchange sales alone would be less than civilian sales. Thus, it is not clear that the

Defense Department study contradicts the ACIR sales estimates since, if all military store cigarette sales were included, the Department of Defense calculations, even using the higher population or customer base, might well indicate higher military purchases per capita vis-a-vis civilian purchases per capita.

The higher per capita sales figures for military store patrons presented in Table 6 suggest either that military people consume more cigarettes, on the average, than do civilians (and this mainly in high-tax states), or that some military persons are buying tax-free cigarettes for the consumption of parties other than themselves and their dependents. Lacking any a priori reason for supposing that the military are heavier smokers than civilians or that high taxes promote heavy smoking, staff must conclude that there is a significant amount of cigarette bootlegging (possibly extending to liquor and other military store items). If the figures in Table 6 are even approximately indicative of the actual practices, they suggest that the attention devoted to the cigarette bootlegging problem by state tax administrators and military officials is certainly justified, but that current enforcement activities are inadequate.

Examples of correspondence with state tax officials and others indicating the extent and types of bootlegging activities are set forth in an appendix to this study.

TABLE 6: ESTIMATES OF PER CAPITA CIGARETTE SALES AMONG CIVILIAN
AND MILITARY STORE PATRON POPULATIONS
AGE 18 AND OVER -- FY 1973

State (Tax Rate)	Civilian Store Per Capita Sales (Packs)	Military Store Per Capita Sales (Packs)
California (10 cents)	184	258
Connecticut (21 cents)	163	193
Florida (17 cents)	188	236
New Jersey (19 cents)	178	248
New York (15 cents)	175	248
North Carolina (2 cents)	350	222
Texas (18 1/2 cents)	171	233
Virginia (2 1/2 cents)	227	218
Washington (16 cents)	144	247

Note: Military per capita sales computed using the following assumptions: 95 percent of military tobacco sales are assumed to be cigarette sales; cigarettes are assumed sold at an average price of 27 cents. The military store patron population aged 18 years and over is assumed to be made up of 100 percent of active duty military personnel and their wives and retired military personnel, plus four percent of the group classified as 'other dependents' of active duty personnel, plus 50 percent of the group classified as dependents of retired personnel. This total was then increased by 3.6 percent to reflect purchasers not included in the above groups based on an AAFES survey of commissary patrons to arrive at the total patron population. Resident non-military population was used to compute civilian sales figures.

Source: National Tobacco Tax Association (Federation of Tax Administrators), Military Markets Fact Book, 1973, ACIR staff estimates.

RECOMMENDATIONS

These findings provide the background against which to examine the first issue--whether the tax-exempt status of on-base sales to military personnel should be changed.

There are at least four policy options available to the Commission:

1. Status Quo. The Commission can recommend that the tax-exempt military store privilege be left undisturbed.

2. Cigarette and Tobacco Taxation. The Commission can recommend that state cigarette and tobacco taxes be applied to military store sales of these items while leaving the rest of the exemption intact.

3. Limited State and Local Taxation of Military Store Sales. The Commission can recommend that cigarette and tobacco taxes be imposed on military store sales of these items, and that the tax-exempt privilege as it relates to other goods be reserved for active duty military personnel and their dependents, thereby excluding certain other groups (primarily the retired military personnel) which now may shop tax-free at military stores.

4. Termination of the Privilege. The Commission can recommend that all state and local sales and excise taxes be applied to military store sales.



RECOMMENDATION A: THE STATUS QUO

The Commission recognizes the problems caused by the differential state and local taxation of on-base sales to military persons as mandated by the Buck Act. The Commission nevertheless recommends that this special treatment granted military personnel be continued because there still remains a sufficient "difference" between military and civilian lifestyles and obligations to warrant this special treatment.

Pro Arguments

The arguments in favor of the status quo are essentially that despite certain adverse findings there are still persuasive reasons for granting special treatment to military personnel.

Military employees are different from other citizens in many ways, and these differences can justify special treatment. Military employees are not, in general, beneficiaries of the civil justice system provided by the states and localities. Those military employees (and their dependents) who live in on-base housing do not make use of civilian police, fire, and environmental services which civilians normally do. Many military personnel make use of state-local services which are significantly different in type or amount from those used by non-military persons, and hence should not be required to pay taxes for services they do not consume.

It should not be thought that military persons pay no state-local taxes whatever. Quite the contrary, they pay normal state-local sales and excise taxes on all off-base purchases of goods and services, and are liable for all state-local motor fuel and income taxes on income other than military pay. (Income tax on military pay is restricted to the state of domicile.) In addition, those military families living off-base pay normal real estate taxes.

Another argument in favor of the current preferential treatment of on-base sales is that most military employees have relatively little control over their duty station assignment. The commissary and PX system was designed, in part, to provide goods and services at fairly uniform prices throughout the nation in order to limit windfall losses in living standards caused by duty station transfers.

It should also be noted that the states and localities have no inherent or Constitutional right to tax in Federal areas. To the extent that they can tax transactions in these areas now (e.g., sales in national parks and nongovernment sales on military bases), it is because of specific actions by the Congress. There is no presumptive case reason for the extension of this taxing authority to all on-base retail sales at this time.

Also, it may be argued that the people of the United States have a moral commitment to maintain this tax advantage for military people. Current commissary and PX patrons may feel that they were assured of their right to the tax-free privilege when they first entered the military. To withdraw this right now would be to go back on a promise that was made and taken in good faith.

The con arguments to Recommendation A are essentially the pro arguments to Recommendations B, C, and D. Opponents of maintaining the status quo argue that exempting military base sales from state-local taxes leads to a large state-local tax subsidy of military purchases, causes business volume loss for off base retail sales outlets, works against the goal of an equitable tax system, and leads to bootlegging of the cheaper PX commodities for illegal off base resale--particularly of cigarettes.

Con Arguments

Opponents of Recommendation A would also point out that no "moral commitment" exists to continue the tax-exempt privilege for persons currently or previously employed by the armed forces. The military store tax status is correctly viewed by military persons as a privilege--not a right. It is as appropriate to reexamine military privileges as it is to reexamine military compensation and obligations as the nature of military service changes.

RECOMMENDATION B: CIGARETTE AND TOBACCO TAXATION

The Commission finds that the exemption of on-base sales to military personnel through military stores has resulted in considerable state-local tax subsidization of military purchases. State and local revenues have been lost both directly and through bootlegging activities associated with the lower on-base prices. However, while the Commission finds that the scope of the state-local tax exemption should be narrowed, it nevertheless feels that the basic privilege should be continued. The Commission therefore recommends that Congress give early and favorable consideration to legislation amending the Buck Act to allow the states to impose cigarette and tobacco taxes on military store sales of these items.

Pro Arguments

Those who would in favor Recommendation B would have two basic arguments. First, they would note that, despite efforts made thus far by military and civilian authorities, cigarette bootlegging is still a fact. While other items (notably liquor) are probably also purchased at military stores for eventual consumption by non-authorized persons, it is appropriate to focus on the cigarette problem because of the

nature of the goods involved. Quantities of cigarettes are easily transported and easily marketed. In addition, it is the opinion of many state tax administrators that most of the 'bootlegging' activities that now take place involve small quantities which military persons pass on to friends and relatives. Such illegal sales are nearly impossible to halt.

Second, the tax loss or implicit tax subsidy is relatively highly concentrated in cigarettes -- ACIR staff estimates for 1973 indicate that nearly half of the total state tax subsidy to military persons through tax-free military store sales was concentrated in cigarette taxes. Hence this action would represent a relatively easy way to reduce significantly the state tax subsidy of military purchases.

Third, the elimination of cigarette bootlegging will strengthen rather than weaken the basic exemption privilege since it will eliminate the most obvious area of abuse of the privilege.

Con Arguments

Those opposing Recommendation B would argue that there is no reason to impose state cigarette and tobacco taxes to on-base sales. They would point to military

efforts to limit bootlegging -- restricted sale quantities and military enforcement actions undertaken in cooperation with state tax officials. They would argue, along with the proponents of Recommendation A, that there exists sufficient reason to treat military persons differently. If the tax-exemption of military store cigarettes is a significant benefit to military persons, they would note, it is one which was promised the military person on enlistment and hence there exists a moral commitment to perpetuate this benefit.

They would also argue that it is dangerous to allow even limited state and local taxation of military store sales. Cigarette and tobacco taxation could be used as a wedge by those wishing to destroy the special tax status of military store sales. Further there is no basis for extending state-local taxing authority to some goods and not others.

RECOMMENDATION C: LIMITED STATE AND LOCAL TAXATION OF MILITARY STORE SALES

The Commission finds that the exemption of on-base sales to military personnel through military stores has resulted in a considerable state-local tax subsidization of military persons both because of lost tax revenues directly and due to bootlegging activities associated with the lower on-base prices. However, while the Commission

finds that the scope of the state-local tax exemption should be narrowed, it nevertheless feels that the basic privilege should be continued for military personnel on active duty and their dependents. The Commission therefore recommends that Congress give early and favorable consideration to legislation amending the Buck Act to:

- allow states to impose cigarette and tobacco taxes on the on base sales of these items;
- allow states to impose their taxes on the sale of alcoholic beverages;
- restrict the current tax-exempt status to active duty military personnel and their dependents only (i.e., prohibit tax-free sales to military retirees and others).

Pro Arguments

The pro arguments to Recommendation C are basically that allowing state tobacco taxation of military sales would do much to lessen the revenue loss to subnational governments associated with the Buck Act provisions. This action also would end the bootlegging of military cigarettes. Limiting the sales tax exemption to active-duty, military personnel would add equity to state-local tax systems.

Tobacco product sales currently account for about seven percent of on-base retail sales. Yet the tax loss to state governments of exempting these items is put at over \$130 million--nearly as much as the state sales tax loss on all remaining on-base sales. All 50 states currently impose tobacco taxes. If Recommendation C were implemented,

roughly 60 percent of the current state tax subsidy to military store patrons would be recouped without affecting the basic tax status of active duty military personnel.

In addition to these sales and cigarette tax losses, states also lose revenues due to the exclusion of on-base sales of alcoholic beverages from state liquor taxes. Although the exact magnitude of the tax loss here is hard to gauge, over \$350 million in liquor sales currently escape taxation. Hence the revenue loss here, too, is clearly significant.

Many of the pro arguments set forth for Recommendation A do not apply to military retirees and others who currently may shop at military stores. There is no presumptive case for granting them an exemption from state-local taxes when they make purchases at on-base outlets. This exemption should be ended to put military retirees on a par with retired civilian workers. Military retirees, unlike active duty military persons, are free to live where they please in almost all cases. In many cases, in fact, they live far from military stores now and make use of them only infrequently. Additionally, it may be argued that it is difficult to rationalize the current extension of the military store tax exemption status to retirees and others on the basis of need. The current military retirement system has been described as "excessively liberal" in a Department of Defense publication, The Proposed New Military Nondisability Retirement System. This report indicated that the average military retirement age is 40-45 (vs. a civilian average of

age 65). Many military retirees, because of their relatively early retirement age, are able to supplement their pension income with full-time employment.

Excluding retirees and others from the list of those granted the state-local tax exemption would significantly reduce the revenue loss to state-local governments, and hence reduce the implicit subsidy which these governments currently pay to the military population.

The differentiation between tax-exempt and taxable purchasers could easily be implemented through the use of existing I.D. cards which are required to gain admittance to military stores.

Con Arguments

The con arguments are basically the pro arguments to Recommendations A and B. Proponents of A would argue that the current exemption of on-base sales is fair and that military persons--including retirees--are sufficiently "different" from other citizens to justify this special treatment.

Opponents to Recommendation C would point out that military pensions are not based on current high pay levels, but are determined by that level which prevailed during the retiree's military career. Hence, they would note, many military pensions are relatively meager.^{1/} They would point out the importance of the tax-exemption benefit to widows, the disabled, and others who currently make use of the military store system.

^{1/} It should be noted, however, that the pensions of military retirees are adjusted for changes in the cost of living.

They would also point out the administrative problems which would have to be dealt with if some military store purchasers were granted a tax-exempt status while others were not.

Finally they would note that all these groups (retirees, widows, reservists, and others) were in effect promised special tax status when they entered military life, and there exists a moral commitment to continue these benefits.

RECOMMENDATION D: TERMINATION OF THE PRIVILEGE

The Commission concludes that the current exemption of on-base sales to military personnel from state and local taxation should be removed. The Commission therefore recommends that the Congress give early and favorable consideration to legislation amending the Buck Act to allow the application of state and local sales and excise (including tobacco and liquor) taxes to all military store sales in the United States. If the Congress is unwilling to remove the exemption, it should compensate the states for their revenue losses.

Pro Arguments

Many of the pro arguments for Recommendations B and C are also pro arguments for Recommendation D. These are basically that state revenue losses would be cut, bootlegging would be curtailed, and some measure of improved equity would be introduced into the state-local tax system.

More basic, however, is the argument that there is no longer sufficient reason for the continuation of the

tax-exempt privilege now granted military personnel, active duty reservists, military retirees and their respective dependents and others. The advent of the all-volunteer armed forces has been accompanied by a change in the general military lifestyle and substantial increases in military pay. These changes, taken together with changes in the role of the tax exemption and the structure of state sales and excise taxes, have undercut the rationale for the military store tax exemption. Thus, there is no obligation on the part of the Federal government to perpetuate this this privilege.

Many civilian employers operate discount sales outlets for their employees--yet it is only the military which is able to free its employees from the burden of state and local taxes. Policemen and firemen are "public protectors" in roughly the same sense as military employees, yet they pay all state and local taxes.

The revenue loss to state and local governments has also been significant. At least \$135 million was lost due to the state sales tax exemption and \$130 million due to the state tobacco tax exemption in 1973 alone. As the table below shows, these losses were substantial in some states:

Estimated State Tax Subsidies--FY 1973

<u>State</u>	<u>Sales Tax Loss</u>	<u>Cigarette Tax Loss</u>
California	\$ 26,507,000	\$ 22,583,000
Florida	8,220,000	13,751,000
Texas	10,800,000	19,344,000
Virginia	10,172,000	1,693,000
Washington	5,702,000	5,802,000

Source: Table 2.

In addition to these sales and cigarette tax losses, states also lose revenues due to the exclusion of on-base sales of alcoholic beverages from state liquor taxes. Although the exact magnitude of the tax loss here is hard to gauge, over \$350 million in liquor sales currently escape taxation. Hence the revenue loss here, too, is clearly significant.

These tax losses are, in fact, subsidies which state governments implicitly pay to Federal military employees, their dependents and to retirees. If such a subsidy is necessary, the Federal Government should pick up the tab and not mandate these costs to state and local governments.

The tax exempt status of on-base sales has obviously siphoned business away from the private sector in communities near military bases. The tax-related price differential is

one of the reasons that the military commissary system has grown to be the ninth largest supermarket chain in the U.S., and the PX system the seventh largest department store chain. Some parity would be restored between on-and off-base sales outlets if the military tax privilege were terminated.

Removing the differential treatment of the military in this area may also result in improved public attitudes toward the military sector. In the past, differences between treatment of military and civilian citizens has sometimes lead to accusations of 'elitism' among the military. Restoring parity in the manner suggested by Recommendation D would contribute to lessening this criticism.

Con Arguments

The con arguments for Recommendation D are essentially the pro arguments for A, B and C. These are, in the A case, that the military is an institution sufficiently different from other employers to warrant special treatment. Military employees should not be subject to sales and excise taxes levied on all of their purchases when they do not make full use of the state-local services which these taxes support. Federal jurisdiction over military bases should not be further eroded by extending state-local taxing authority carte blanche over these areas.

Additionally, the tax free privilege is sometimes used as a recruiting inducement by the military. Doing away with this unique status could add to recruiting problems for the military and increase costs or lower the effectiveness of current recruiting efforts.

Those who oppose the termination of the tax-exempt status of military store sales would also point out that many localities currently receive school impact aid payments from the Federal Government which could conceivably be interpreted as being payments in lieu of sales or excise taxes. The state and local governments should consider the possibility, they would note, that these grants might be terminated if the military store tax status were changed. This could have a disruptive impact on finances of certain states and localities since the governmental units which would receive the sales and excise taxes are generally not the same ones that currently receive the Federal aid payments.

Finally, opponents of D would argue that there exists a moral obligation to continue the tax exempt status of military store sales since those now reaping the benefits of this status were in effect promised it when they entered military life and have come to count upon the benefit.

FOOTNOTES TO CHAPTER 2

- 1/ Quoted in the General Accounting Office's report to the Congress entitled, "The Military Commissary Store: Its Justification and Role in Today's Military Environment" (GAO: May 21, 1975) p.1.
- 2/ "The Military Commissary Store: Its Justification and Role in Today's Military Environment." op. cit. p.7.
- 3/ Although subnational governments may not, of their own volition, tax Federal entities or impose taxes in areas of exclusive Federal jurisdiction, the Federal government may extend to them the right. This has already been done in several areas including sales and excise taxation within national parks, state taxation of gasoline on military reservations and, as per the provisions of the Buck Act, state taxation of non-government sales on military bases.
- 4/ The Department of Defense has disputed the ACIR staff estimates on military per capita cigarette sales. In a letter to the Commission, a Defense Department representative stated:

"The Army and Air Force Exchange Service (AAFES), the largest of the three exchange systems, examined per capita consumption of cigarettes among their patrons. The publication, "The Tax Burden on Tobacco" . . . indicates that in fiscal year 1974 the national consumption of cigarettes averaged 141.7 packages per person. Records of AAFES reveals that during the most recent fiscal year (FY 75) approximately 29,862,000 cartons of cigarettes were sold in exchanges under AAFES in the continental United States. Records also indicate AAFES has 5,236,700 authorized customers, which can be equated to 57 packages per year per customer, far below the national average of 141.7 packages per person."

This military estimate of per capita sales would indicate that either military persons consume fewer cigarettes than their non-military counterparts or they buy most of their cigarettes in non-military stores. In either case, the net flow of cigarettes would be into military bases, not out of them as suggested by the ACIR staff estimates.

CHAPTER 3. STATE-LOCAL TAXATION OF MILITARY PAY

INTRODUCTION

Relevant Federal and State Laws

Federal Provisions.--The ability of states (and local-
ities)^{1/} to make full, effective, and equitable use of personal
income taxation is constrained by Federal provisions pertaining
to the taxation of military pay. \

-- The Soldiers' and Sailors' Civil Relief Act
of 1940 provides that military duty pay
can be taxed only by the state in which
the armed forces member is domiciled, or
is a legal resident;^{2/} and

-- Under P.L. 82-587, The District of Columbia
Revenue Act of 1956, and P.L. 93-340, state
and local income taxes may not be withheld
from military compensation.^{3/}

These Federal provisions mandate a state-local tax treat-
ment of military pay that is different from the tax treatment of
civilian pay--and different, even, from the state-local tax rules
that apply to non-military income of military personnel and their
families--and they tend to discourage or limit the application of
state income taxes to military pay.

A third Federal statute, however, has the opposite tendency
and broadens the applicability of state income taxes: the Buck Act

provides that persons otherwise liable for state income taxes shall not be relieved of responsibility for such taxes solely because they live in and/or work in areas of Federal legislative jurisdiction.^{4/} This does not affect the domicile-only jurisdictional rule governing taxation of military pay, but it does make the tax laws of a state applicable to a domiciliary of that state--whether civilian or military--who lives in and/or derives income in a Federal area within that state.

The net effect of the Federal provisions affecting state-local taxation of military pay, although not quantifiable, clearly discourages and restricts the use of income taxes.

State Provisions.--Based upon state income tax laws applicable for the 1974 tax year, about half of the 40 states with broad-based income taxes^{5/} provide for less comprehensive taxation of military pay than the Federal Government^{6/} (Appendix A).

At the extreme, five states (Alaska, Illinois, Iowa, Michigan, and Vermont) completely exempt active duty pay from taxation. Another three (California, Idaho, and Pennsylvania) exempt from their income taxes military pay arising from military service outside that state, and the provisions of several other states may have the effect of exempting military pay for service outside the state.^{7/} Ten states, including some of those listed above as well as seven other states, provide for exclusion of some

amount of military compensation that is taxable under the Federal personal income tax--e.g., \$1,000 in Wisconsin.^{8/}

Proponents of such exemptions for military pay use two basic types of arguments--patriotism and administrative/compliance ease. The first simply argues that full or partial exemption of military pay is a desirable expression of public gratitude toward the men and women serving their country in the armed forces. The second is more practical. While domiciliaries stationed outside the state are taxable by the state of domicile, exemption proponents argue that because such persons are not located within the state it is difficult to collect the income tax from them; the absence of withholding makes this doubly true.^{9/}

One possible outcome that all parties--tax administrators, politicians, and military personnel--wish to avoid is the hardship case in which a returning service man is confronted with an unpaid tax bill for several years' taxes. This second rationale for exemption of military pay earned outside the state is buttressed by the benefits-received theory of taxation--since military personnel stationed outside a given state are unlikely to be receiving significant benefits from that state's services, exempting their pay from the state income tax is said to be logical.

Similarly, an equity argument can be made for full exemption of military pay, given the tax treatment mandated by the Soldiers' and Sailors' Civil Relief Act. Because this

Federal statute makes it impossible to tax all military personnel stationed within a given state, it is argued that taxing some of them (those domiciled in the state where they are stationed) constitutes inequitable treatment of some military persons (the "home folks," at that) vis-a-vis other military persons living and working in the same place. Although full exemption of military pay can be viewed as a remedy to this Federally-mandated inequity, it worsens another type of inequity--that between civilians and the military. Again, inability to institute withholding reinforces any tendency to exempt military pay.

The states' exemption policies raise problems that will be examined in subsequent portions of this chapter.

Significance of Domicile and Residence Concepts

The Federal and state laws noted above make reference to "domicile" and "residence," so that some understanding of these terms is necessary for discussion of the issues discussed in this chapter.

When a distinction is drawn between "residence" and "domicile," it generally is on the basis of intention and the permanence of one's attachment to an area:

Residence means living in a particular locality, but domicil means living in that locality with intent to make it a fixed and permanent home. Residence simply requires bodily presence as an inhabitant in a given place, while domicil requires bodily presence in that place and also an intention to make it one's domicil.10/

But once domicile has been established, physical presence is not necessary to maintain domicile. Thus, a person can be domiciled in one jurisdiction and simultaneously be a resident of another:

In addition to its being a permanent home, domicil involves an element of intention, that is, it is a place to which, during an absence, one has the intention of returning and from which he has no present intention of moving. ... (D)omicil is said to be inclusive of residence, having a broader and more comprehensive meaning than residence. Residence, together with the requisite intent, is necessary to acquire domicil but actual residence is not necessary to preserve a domicil after it is once acquired. Consequently, one may be a resident of one jurisdiction while having a domicil in another. And while every person has one and only one domicil a person may have no place which can be called his residence or he may have several such places.11/

State income taxes commonly apply to all income (regardless of where derived) of a "resident," as well as to income of a non-resident derived within the state. The definition of a resident differs among the states, but it encompasses one or more of the following groups: (a) persons domiciled in the state; (b) persons actually present within

the state, either for a specified length of time or for other than temporary purposes; and (c) persons who maintain a permanent place of abode within the state.^{12/} Thus, a state's concept of residence for tax purposes may include those domiciled in the state, whether or not they are physically present.

The Soldiers' and Sailors' Civil Relief Act precludes state taxation of military pay by a state in which the recipient ". . . is not a resident or in which he is not domiciled,^{13/} . . .":

For the purposes of taxation in respect of the personal property, income, or gross income of any [member of the armed forces] by any State, Territory, possession, or political subdivision of any of the foregoing, or the District of Columbia, of which such a person is not a resident or in which he is not domiciled, compensation for military or naval service shall not be deemed income for services performed within, or from sources within, such State, Territory, possession, political subdivision, or District, . . .^{14/}

This provision is understood to preclude state income taxation of military pay by any state other than the recipient's domicile state; the term "resident" appears to mean "legal resident" and to be synonymous with domicile. The Office of the Judge Advocate General of the Air Force, for example, has written that "the [Soldiers' and Sailors' Civil Relief] Act provides, substantially, that a member of the Armed Forces who is legally resident in one state but

is living in another solely by reason of military orders, is not liable to the second state for income taxes with respect to service pay."^{15/}

To so construe the meaning of the word "resident" is not without precedent:

A distinction between "legal residence" and "actual residence" has been recognized; "actual residence" has connotations of a more temporary character, while the phrase "legal residence" is sometimes used as the equivalent of "domicile."^{16/}

Because some state income taxes apply to "legal residents" or "domiciliaries" even when they are not "actual residents," there exists the possibility that a person who lives the entire tax year in a single state still may have a state income tax liability to a different state (his state of domicile) --even if all his income was derived in the state in which he actually resided. This situation, together with the different definitions of residence used in the several states and the importance of intent in the determination of domicile, creates certain complexities in the area of state income taxation--both for taxpayers and for tax administrators--although these complexities have been handled pretty well by the states.

The section of the Soldiers' and Sailors' Civil Relief Act quoted above attempts to relieve armed forces members from concern for these complexities and from the threat of double

taxation with respect to their military pay. Desirable as this objective may be, this Federal statute also has the effect of precluding taxation of military pay by the state in which the military member is physically present if his domicile is in another state, contrary to the application of state income tax laws to civilians and even to the non-military pay of military members.

Implications of Federal Provisions: An Overview

The general implications of Federal restrictions on state-local taxation of military pay with regard to both withholding and jurisdictional standard are listed below and discussed more fully in subsequent section.

Equity.--Tax equity is impaired directly by the Federal provisions because it is not possible for a state to tax the incomes of some persons who live and/or earn income in that state and enjoy service benefits funded by the state personal income tax. At best, some members of the armed forces will contribute income taxes toward funding state services where they are stationed while others will not. Interpersonal equity cannot be achieved either among military personnel or between military and civilian personnel. Moreover, the domicile rule may cause the military to resent state taxes because such taxes frequently will be paid to a state to which the member currently has no close ties.

If, in an attempt to treat all military personnel within the state similarly, a state exempts all military pay from income taxation, a situation which treats some military personnel inequitably vis-a-vis other military personnel is simply traded for a situation that treats civilians inequitably vis-a-vis the total military. The taxes necessary to support a given level of services then must come from a still narrower segment of the population. Tax exclusions or exemptions for the military translate directly into higher taxes for the rest of the population and/or reduced public services for all. Such exclusions or exemptions base tax liability on the source or type of income, rather than the amount, and are inconsistent with the basic rationale for income taxation.

Compliance and Administrative Costs.--Military personnel find the fulfillment of their state tax obligations more difficult because they are denied the convenience of making tax payments through regular payroll deductions--a convenience accorded almost universally, except for military pay.^{17/} Absence of withholding means that taxes must be paid in much larger quarterly or annual "lumps," through a payment process that must be initiated by the taxpayer. In some instances tax returns must be filed with two states, making filing more complex and time-consuming, simply because of the Federally-mandated rules concerning what state can tax military pay. Thus, tax

compliance for the military family is made more difficult by the Federal statutes concerning state taxation of military pay.

The Federal provisions also complicate tax administration. Collection of income taxes is facilitated greatly by withholding, which is prohibited for taxes on military pay. Moreover, because any given state can tax the military pay of only its domiciliaries, wherever they may be stationed, state tax officials must identify and locate the military personnel claiming domicile in the state, get forms to them, and then collect the taxes due. The distances involved also complicate auditing and make it more costly. (The problems discussed here also generate significant tax avoidance and evasion, which we address later.)

Tax Base Erosion.--Confronted with the administrative and compliance difficulties inherent in the taxation of military pay, there is a tendency for state tax administrators and policymakers to conclude that the best option available under current Federal statutes is to exempt military pay attributable to service outside the domicile state; as noted, three states already have done so, provisions in a half dozen other states appear to have this effect for many service persons, and similar legislation has been proposed in other states.^{18/} Or the inequitable tax treatment that must be accorded military personnel stationed at the same base but domiciled in different

states may influence state policy makers to totally exempt military pay, as six states already have done.^{19/} These moves directly erode a state's tax base and also diminish tax equity--especially the full exemption.^{20/} They may also constitute an opening wedge for further tax base erosion by giving other groups an issue upon which to seize and argue that they, too, are "different" and deserving of preferential tax treatment.^{21/} Military pay now represents a sizable income stream, and its exclusion from state income tax bases would represent significant base erosion--more significant in some states and localities than in others.

Revenue Loss.--Another implication of the Federal provisions concerning state taxation of military pay is that the states in the aggregate suffer a revenue loss. This occurs in three ways: (1) inability to tax the military pay of non-domiciliary service personnel stationed within the state--a situation that is made more important by the ability of the military to select domicile status in part on the basis of income tax advantage; (2) incomplete tax compliance by military personnel--whether inadvertently through confusion and absence of withholding, or through deliberate tax evasion by failure to file or by illegally claiming domicile in a state with favorable tax laws; and (3) state military pay exclusion provisions encouraged by the current Federal laws. The first of these is beyond the control of an individual state--Federal action

is required; part of the second can be dealt with to some extent by a single state through an active taxpayer education and audit program, but the situation could be improved more completely and economically by changes in Federal policies; and the third is within the control of each state, although, as noted, Federal policies tend to encourage exemption by the states.

Distortion of Tax Source Choice.--Federal law clearly is not neutral with respect to state and local choice of tax sources. The Federal provisions will tend to make personal income taxation relatively less attractive to states and localities with a substantial military presence. Whatever influence there is would be expected to be stronger at the local level because the military comprise a much larger portion of the population in some local jurisdictions than they do in any state.

If a jurisdiction with a large military population decides to place significant reliance upon an income tax, it is deciding to have civilians and domiciliary military personnel subsidize the public services consumed by non-domiciliary military personnel. The greater the percentage of non-domiciliary military in the citizenry, the greater the burden on the rest of the populace. The subsidy problem is still present but somewhat less severe where sales and excise taxes are used, because the percentage of a military family's consumption expenditures made in tax-exempt commissaries and exchanges



typically is less than the percentage of its income comprised of tax-exempt military pay and allowances. (Most states have "mixed" fiscal systems with both income and sales tax subsidies for the military.) Because domicile is not a factor in determining residential property tax liability, there is no real property tax subsidy for military families living in private housing rather than in tax-exempt, government-owned housing. Recognition of the differential subsidy effects inherent in different types of taxes constitutes a somewhat greater obstacle to significant shifts away from property taxation by localities with large military populations.

DISCUSSION OF ISSUES AND FINDINGS

The previous sections have described the current legal provisions regarding state-local taxation of military pay and briefly noted some of the principal implications of those provisions. In this section the issues raised are discussed more fully and findings are stated.

Federal Law Impairs State Income Tax Equity

The Soldiers' and Sailors' Civil Relief Act mandates a different state-local income tax treatment of military pay vis-a-vis other types of income--namely, that military pay can be taxed only by the state in which domicile is claimed by the recipient of such pay. Inequitable taxation is guaranteed

by this provision. Several ways or instances in which this inequity manifests itself are discussed below with examples to illustrate them.

Effects on Taxpayers of Host Jurisdiction.--An important equity implication of the tax treatment of military pay is that it operates to increase taxes and/or reduce the level of services for taxpayers in the host jurisdiction (i.e., the jurisdiction, state or local, in which non-domiciliary military personnel live and/or work) if personal income taxes are levied in that jurisdiction.^{22/} For example, Captain Brown is domiciled in New York but is stationed in Maryland. He sends his two children to Maryland schools, uses Maryland parks and highways, and so on, but his military compensation is beyond the reach of Maryland's state and local income taxes. Other Maryland taxpayers must pay higher taxes (or consume less service) than they would if the pay of Captain Brown and other military personnel stationed, but not domiciled, in Maryland were taxable in Maryland.

At the state level, the percentage of the population comprised of military personnel and their dependents typically (although not universally) is rather small--two percent or less.^{23/} For this reason, some may argue that the problem is not very significant--that revenue foregone will not comprise

a large share of total revenue. As a general rule this must be true, but the dollar amounts still may be significant. Using the Maryland example once more, it is estimated that total state personal income tax liability for all active duty military personnel living in Maryland would be about \$10 million.^{24/} This amount would not all be new revenue for Maryland if military pay were taxable by the state where military personnel are physically present.^{25/} Some military personnel in Maryland are domiciliaries of Maryland and already are liable for the state income tax, and therefore would not represent a new source of revenue. Additionally, under a physical-presence rule, Maryland would lose some tax revenue from Maryland domiciliaries stationed outside the state. Just what the net revenue gain would be is not known, but in a state such as Maryland, with a relatively large concentration of military, it seems probable that something over half the gross military liability--i.e., \$5 to \$6 million--would represent a net gain. While this is a small percentage (about 1 percent) of Maryland state income tax collections, it clearly would make a significant contribution toward marginal state spending increases--such as the \$16 million annual cost of the new (and difficult-to-fund) Maryland property tax circuit-breaker for low-income elderly homeowners.

At the local level, of course, the variability in the military population as a percentage of total population is greater

than it is among states. Some jurisdictions near military bases have sizable concentrations of military personnel. (For example, two large Virginia jurisdictions in the Washington, D.C., area--Arlington County [1970 population over 174,000] and Fairfax County [1970 population over 455,000]--each had 12 percent of their total 1970 labor forces, and nearly 20 percent of their male labor forces, comprised of active duty military.^{26/}) Such a community may be expected to find an income tax less attractive than a sales tax or a property tax because the income tax would miss much of the jurisdiction's population and income; this would tend to retard local revenue diversification.

Relative Civilian and Non-Domiciliary Military Taxes in Host Jurisdiction.--The immediately preceding discussion dealt with aggregates. We now turn to the question of interpersonal equity on a one-to-one basis of comparison.

Consider Lt. Jones and Mr. Smith. Each has \$10,000 income (excluding Lt. Jones' tax-exempt cash allowances for housing and subsistence), a wife, and two children; they are neighbors. Indiana, the state in which they are living, has a personal income tax levied at a flat rate of 2 percent, after deducting personal exemptions of \$2,000 for taxpayer plus spouse and \$500 per dependent. Thus, both Lt. Jones and Mr. Smith have \$7,000 taxable income, on which the state income tax would be \$140.

But Lt. Jones, domiciled in Texas, is not taxable in Indiana. Thus, because of the Soldiers' and Sailors' Civil Relief Act, two similarly situated families living in the same city and enjoying the same public services pay quite different state taxes--the civilian pays the full tax while the military person domiciled in another state pays no state income tax to his host state (Indiana). In the example given, because Texas levies no personal income tax, Lt. Jones owes no personal income tax. A later example gives another situation.

Relative Taxes of Domiciliary and Non-Domiciliary

Military Residents of the Host Jurisdiction.--Soldiers' and Sailors' Civil Relief Act provisions also create inequitable tax situations between members of the armed forces, as well as between military and civilians. To illustrate this we can use the foregoing example of Lt. Jones and Mr. Smith, except that we now must substitute Lt. Gray--an Indiana domiciliary stationed in Indiana--for Mr. Smith; all other features of the example are unchanged.

In this slightly reworked example, Lt. Gray has a \$100 Indiana state income tax liability (taxable income is reduced from \$7,000 to \$5,000 by Indiana's exclusion from taxation of the first \$2,000 of military pay), while Lt. Jones, domiciled in Texas, pays no state income tax to Indiana or Texas. It is this comparison between military personnel that has led some states

to conclude that full military pay exemption is necessary to avoid discriminating against the "native sons" vis-a-vis non-domiciliary military personnel (but at the cost of increasing the discrimination against civilians vis-a-vis military).

Resident and Non-Resident Domiciliaries of an Income Tax State.--In 25 states and the District of Columbia, the military pay of a person domiciled in the state is taxable under the state income tax even if he is stationed outside the state and is not in a position to fully benefit from the services financed by the tax. The same basic example can once again be used to demonstrate the inequity of this situation. Assume again two Indiana domiciliaries, both lieutenants, both having \$10,000 basic military pay, both married, and both having two children. Lt. Gray stationed in Indiana, as in the previous example, and Lt. Pierce is stationed in Washington State. Each man owes the \$100 income tax bill calculated above, but only Lt. Gray is in Indiana to consume the services provided from his tax payment. Lt. Pierce is in Washington, a state with no income tax. He will be subject to most Washington taxes (except to the extent that he makes consumption purchases on base--see the previous chapter), even though he is domiciled in Indiana and must pay the Indiana income tax (on all but \$2,000 of his military income). Lt. Pierce's situation illustrates the fact that differential tax treatment of military pay is not always preferential treatment.

Military and Civilian Domiciliaries of a Non-Income Tax State Living in an Income Tax State.--The tax treatment of military income mandated by the Soldiers' and Sailors' Civil Relief Act, as noted, is different from that accorded civilian pay. Civilians typically are subject to tax where they are living and/or working, regardless of where they claim legal residence or domicile.

Consider Col. Maxwell and Dr. Arthur, two domiciliaries of Florida currently living in Virginia; Dr. Arthur is a college professor on a year's leave with a Federal Government agency. Col. Maxwell's basic pay (excluding tax-exempt allowances) is \$25,000, the same amount that Dr. Arthur is receiving. The effective rate of Virginia income tax for a \$25,000 adjusted gross income is 3.3 percent or \$825. Because Dr. Arthur is a civilian, Virginia can and does impose this tax on him; because Col. Maxwell is in the military and domiciled outside Virginia, Virginia cannot impose this tax on him. Yet both live in the same Washington suburb, have the same income (ignoring military allowances), the same number of dependents, and the same state and local public services. Neither, of course, pays an income tax to Florida because this state does not employ the tax.

Federal Provisions Facilitate
State Income Tax Avoidance

Under Federal law, each state is limited to taxing military pay of only its own domiciliaries--including those stationed out-

side the state. In addition, Federal law prohibits withholding of state income taxes from military pay. This combination means that military personnel stationed outside their domicile state may inadvertently neglect to file income tax returns, perhaps through confusion as to liability for state income taxes. Moreover, the circumstances make it difficult for state tax officials to identify those who should be filing income tax returns, to get forms to them, to collect the taxes due, and to audit the taxpayers.^{27/}

In addition to such unwitting tax avoidance, the confusion arising from current provisions facilitates deliberate evasion by those inclined to shirk their state tax obligation. One means of doing this is simply not to file even if the domicile state taxes military pay. This evasion may be identifiable through diligent and costly state tax administration and interstate cooperation among tax administrators, even in the absence of withholding. A member of the armed forces can avoid state income taxes by selecting a domicile state on the basis of tax advantage. The presence of 15 states that do not tax military pay at all (the 10 non-income tax states and the five income tax states with a full military pay exemption) makes complete avoidance of state income taxation on military pay quite feasible. Selection of a domicile state on this basis is legal, provided

the state's requirements for establishing domicile are met. It is legal avoidance of state income taxes, thanks to a Federally-created loophole. A civilian also may change his domicile, of course, but such a change does not have the same implications for the civilian's state income tax liability--a civilian living or working in an income tax state will be liable for that state's tax regardless of domicile.

If requirements for establishing domicile have not been met, a tax-influenced naming of a new domicile state is illegal tax evasion. It is difficult for state tax administrators to know whether domicile has been properly claimed (or not claimed), in part because intent is so important in determining domicile, and in part because current state tax administration practices applicable to the military make it possible for a military member to "fall between the cracks" in the absence of truly extraordinary efforts by state officials. Suppose Joe Smith is in the Army and claims to be domiciled in Florida, but that he has not met the Florida domicile requirements and actually is a domiciliary of Ohio and should be filing an income tax return in Ohio. If Smith does not file an Ohio return, how will Ohio tax officials know that he should file? If his Federal income tax return is filed from an Ohio address, this would provide a lead--but it may be filed from his current duty station in, say,

Oklahoma. If a declaration of legal residence has been obtained under the OMB A-38 procedure, it would show Florida as the domicile state in this case (the Army, and the other services are not required--appropriately--to verify the accuracy of a member's declaration of domicile); if such a declaration has not been obtained, Smith's wage statement would be sent to Oklahoma. In neither event would Ohio receive the wage statement.

Or suppose that for some reason Ohio tax officials obtain Joe Smith's name. Upon discovering that they have no income tax return on file for him, they may contact him; Smith's probable response will be that he is domiciled in Florida. To verify the accuracy of this statement, Ohio must contact Florida officials, who would then have to check into the particulars of the Smith case to determine whether he is legally claiming domicile in Florida. Thus, interstate cooperation (involving agencies other than the tax departments) appears to be necessary. To verify the accuracy of this statement, Ohio must contact Florida officials, who would then have to check into the particulars of the Smith case to determine whether he is legally claiming domicile in Florida. Thus, interstate cooperation (involving agencies other than the tax departments) appears to be necessary. Florida, having no income tax payment at stake because

it levies no such tax, may find the burden of checking unreasonable; but Ohio must, to some extent, depend upon Florida officials to assist Ohio's efforts to determine the tax status of Joe Smith. Such verification efforts, moreover, are costly and time-consuming.

Tax Agency Data on Individuals.--There is some fragmentary evidence of significant non-compliance with state income taxes by the military. The tax agencies of the District of Columbia and the State of Maryland followed up on two groups of military personnel who did not file income tax returns with their respective offices: (a) those who filed Federal returns from a D.C. or Maryland address; (b) for whom W-2's had been received under Circular A-38.^{28/} Discrepancies between Federal and state filing do not necessarily indicate unlawful evasion of state taxes, so the mismatches must be checked out. The W-2s, on the other hand, should provide a good indication of where tax returns are to be filed since, under OMB Circular A-38, the armed forces are to supply W-2 information to state and local tax agencies in jurisdictions claimed as legal residence by the service person (although a loophole for a less-than-diligent attempt to get declarations of legal residence is allowed by the provision that W-2s be sent to the state where the service person is serving if a legal residence has not be designated).^{29/}

The Federal/state filing check the District and Maryland conducted was for tax year 1971 and utilized a sample of military personnel who responded to follow-up inquiry that legal residence in another state was the reason for not filing where the Federal return was filed from (i.e., D.C. or Maryland). The results were as follows:

	<u>Number</u>	<u>Percent</u>
Responses followed up	57	100
Claimed domicile in states with no income tax or with full exemption of military pay	23	40
Filed in state claimed as legal residence	15	26
No return on file in state claimed as legal residence	19	34

It should be noted that the sample was small and was not a scientifically-drawn sample that would enable generalizations. The third group clearly was not in compliance with existing laws; the first group may be in compliance, although more detailed investigation would be required to determine whether all those claiming domicile in a state imposing no tax on military pay were doing so legally.

The District and Maryland W-2 test used a random sample of 129 military personnel for whom W-2s were received from the armed forces under A-38. The results are given below:

	<u>Number</u>	<u>Percent</u>
W-2s selected	129	100
Filed with jurisdiction receiving W-2 (D.C. or Maryland)	39	30.2
Filed with another state claimed as legal residence	7	5.4
State claimed as legal residence has no income tax or fully exempts military pay	6	4.7
Filed with state where serving	10	7.8
No return on record in D.C. or Maryland, where such return appeared to be required	67	51.9

The largest group of these persons filed no state income tax return, and less than a third for whom either the District or Maryland received W-2s filed there (again, these results cannot be generalized).

Further evidence of a compliance problem comes from Minnesota, which received only 9,595 state income tax returns from armed forces members for 1974.^{30/} Thus, returns were

received from only 33 percent of the 28,858 armed forces members domiciled in Minnesota in 1974, according to information collected under OMB Circular A-38.^{31/} More generally, the head of the Mississippi income tax division has estimated recently that the states, on average, still fall short of achieving a 50 percent level of compliance by military personnel with state income tax requirements.^{32/}

State-Local Aggregate Data.--In an attempt to obtain data bearing on the question of whether members of the armed forces tend to concentrate their claims of legal residence in states offering favorable tax treatment for military active duty pay, ACIR staff requested state-by-state tabulations from the Pentagon of the W-2 information supplied for 1974 to the various states pursuant to OMB Circular A-38. In particular, we requested (a) the number of persons claiming legal residence for tax purposes, (b) the number of these stationed in the state in which legal residence is claimed, and (c) the number of those claiming legal residence whose military compensation is at a rate less than \$10,000 annually. All services responded, although some were unable to supply all the information requested, particularly for the second and third items. This section is based on these responses.

The 50 states and the District of Columbia were categorized by ACIR into six groups according to state income tax treatment of active duty military pay:

- States having no broad-based personal income tax (10 states: Connecticut, Florida, Nevada, New Hampshire, New Jersey, South Dakota, Tennessee, Texas, Washington, and Wyoming);
- Income tax states that fully exempt military active duty pay (5 states: Alaska, Illinois, Iowa, Michigan, and Vermont);
- Income tax states that exempt all military active duty pay attributable to service outside the state (3 states: California, Idaho, and Pennsylvania);
- Income tax states that do not tax domiciliaries outside the state if they meet three tests concerning place of abode and maximum time within the state (6 states: Maine, Missouri, New York, Oregon, Rhode Island, and West Virginia^{33/});
- Income tax states that offer partial exemptions for military active duty pay, wherever stationed (10 states, only seven of which

are included in this category in the following figures--Arizona, Arkansas, Indiana, Minnesota, North Dakota, Oklahoma, and Wisconsin--because the other three--California, Oregon, and West Virginia--are included in preceding groups; and -- Income tax states that tax active duty military pay, wherever stationed (District of Columbia and 19 states: Alabama, Colorado, Delaware, Georgia, Hawaii, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Mississippi, Montana, Nebraska, New Mexico, North Carolina, Ohio, South Carolina, Utah, and Virginia).

Table 3.1 compares the percentage distributions of military claims of legal residence with the distributions of total population and of military accessions in a recent six-month period.

It seems reasonable to expect that accessions to the military would distribute among the states roughly in proportion with population. (Differences shown in the first two columns of Table 3.1 may be accounted for--no attempt has been made to explain the differences statistically--by such factors as different concentrations of service-age males, differences in other employment opportunities, and differences

Table 3.1--Comparison of Percentage distributions of Population, Military Accessions, and Legal Residence for Tax Purposes of Military Active Duty Personnel Among States Categorized According to State Income Tax Treatment of Military Active Duty Pay

Category (and number) of states for tax year 1974	Percentage of population as of 4/1/73	Percentage of accessions to military services, Jan.-June 1970	Percentage distribution of military personnel among states claimed as legal residence for tax purposes for 1974, by branch of service			
			Air Force	Army	Marine Corps	Navy
States with no broad-based personal income tax (10)	19.0	16.9	24.5	44.26 ^{a/}	19.4	20.2
Income tax states, but with full exemption of military active duty pay (5)	11.4	13.2	8.7	6.5 ^{b/}	10.4	9.6
Income tax states but with full exemption of military active duty pay for service outside the state (3)	15.9	14.1	14.0	6.8	16.8	19.5
Income tax states, but no tax on domiciliaries who meet three tests concerning place of abode and maximum time in the state (6)	13.8	12.4	11.8	8.1 ^{b/}	12.1	11.4
Income tax states, but with modest partial exemption of military active duty pay (7)	10.1	11.7	10.1	7.4	11.2	9.8
Income tax states that tax military active duty pay wherever stationed (19 + D. C.)	29.9	31.7	30.8	27.1	30.3	29.5

Source: See text.

^{a/} Estimated; see footnote 34.

^{b/} Estimated in part; see footnote 34.

in educational attainment. Also, the six-month period for which accessions data were readily available may not have been representative or "typical.") Population distribution is regarded as a good measure of expected distribution of domicile or legal residence for military personnel, if legal residence claims are not affected by state tax considerations (and other factors that would alter the distribution of domicile).

Using service-wide data combining officers and enlisted personnel, Table 3.1 shows only limited support for the hypothesis that military personnel can and do claim legal residence in part on the basis of state income tax advantage. That evidence is pretty much restricted to the Air Force and Army figures for the no-tax states. Thus, non-income-tax states have 19.0 percent of the population, compared with 24.5 percent of Air Force, an estimated 44.2 percent of Army, 19.4 percent of Marine Corps, and 20.2 percent of Navy claims of legal residence.^{34/}

One would expect income tax considerations to exert a stronger influence on higher-paid persons than on lower-paid persons in the selection of a legal residence, and it was with this thought in mind that ACIR requested legal residence by state broken into under-\$10,000 and over-\$10,000 groups. The

three columns in Table 3.2 show relative concentrations of Air Force, and Marine Corps, and Navy personnel receiving military compensation at an annual rate more than \$10,000 (comparable data were not received for the Army) in the six groups of states. The figures in the table are ratios relating the concentration of high-income military personnel in each group of states to the concentration of high-income military in the 50 states and D.C. Specifically, for each service and for each group of states, personnel receiving more than \$10,000 annual military pay were expressed as a percentage of all military personnel in that service and that group of states; comparable percentages were calculated for each service for the 50 states and the District of Columbia as a whole. Within each service, the percentage for each group of states was taken as a ratio of the percentage for the U.S. Thus, a ratio of 1.00 indicates a concentration of high-income military no different from that for the country as a whole, a ratio greater than 1.00 indicates a greater relative concentration of high-income personnel, and a ratio less than 1.00 indicates a lesser concentration, relative to the country as a whole. If income tax considerations are exerting an influence in selection of legal residence, one would expect a disproportionate concentration of personnel earning over \$10,000 in



the no-tax states and a lower-than-average concentration of such persons in states offering no tax concession to military personnel.

The general pattern of the data in Table 3.2 supports this notion; the ratios for all three services were well above one for the no-tax states. Overall, 23 percent of military members are stationed in the 10 non-income tax states.^{35/} But for the three services for which income-level data are available (Army excluded), 29 percent with income above \$10,000 claimed domicile in these states, versus 22 percent for all members of these three services.

In summary, available data suggest rather strongly (if not unequivocally) that many military personnel--and particularly higher-paid personnel--perceive the tax advantages available under current state income tax laws as they apply to the military, and that significant numbers of them take advantage of the opportunity to avoid state income taxes through domicile selection.

Is there a benign explanation for the relatively high percentages of Air Force and Army personnel naming the 10 non-income tax states as their legal residence states, or for the disproportionate concentrations of higher-paid Air Force, Marine Corps, and Navy personnel domiciled in these states? Admittedly, a number of factors that we have not

Figure 3.2 -- Distribution of Air Force, Marine Corps, and Navy Legal Residents with Annual Military Pay Above \$10,000 Among Groups of States Categorized According to State Income Tax Treatment of Military Active Duty Pay, 1974

Category (and number) of states for tax year 1974	Military personnel with annual duty pay above \$10,000 as a percentage of all military personnel claiming legal residence for tax purposes: Ratio, state group % to 50-state %		
	Air Force	Marine Corps	Navy
States with no broad-based personal income tax (10)	1.33	1.24	1.21
Income tax states, but with full exemption of military active duty pay (5)	.99	.82	.88
Income tax states, but with full exemption of military active duty pay for service outside the state (3)	.89	1.17	1.01
Income tax states, but no tax on domiciliaries who meet three tests concerning place of abode and maximum time in state (6)	.85	.95	.97
Income tax states, but with partial exemption of military active duty pay (7)	.89	.71	.78
Income tax states that tax military active duty pay wherever stationed (19 and D. C.)	.89	.93	1.00

Source: See text.

been able to control may come into play. One obvious possibility is that military personnel simply name the states in which they are stationed as their legal residence states. This emphatically is not the case, however, based on data for 1974 supplied by the Air Force, the Marine Corps, and the Navy. In fact, the general picture that emerges is that domicile or legal residence is a state other than the one in which the person is stationed in the overwhelming majority of cases. Marine data, for example, show that only 243 out of 6,837 members claiming domicile in Florida in 1974 were stationed in Florida in that year. This is not atypical. An unusually high correspondence between legal residence and duty station is that reported by the Navy for California-- for 1974, two-thirds of those claiming domicile in California were stationed in California.^{36/}

Federal Law Complicates State
Income Tax Compliance and
Administration

As previously noted, non-compliance may arise either by inadvertence or through willful evasion, and the current situation with respect to state income taxes on military pay enhances the prospects for both forms. The figures in the foregoing sections illustrate this. The District of Columbia

and Maryland data on individuals, for example, revealed that large percentages of the military personnel whose statuses were investigated had not filed state returns in states claimed as legal residence, and that some had filed where they were serving even though they apparently claimed legal residence elsewhere. This suggests confusion on the part of many military persons as to where--or whether--they are supposed to file state tax returns. There also appears to be some legal avoidance by some of those claiming legal residence or domicile in states not taxing military pay, and even illegal tax evasion on the part of some non-filers.

The absence of tax withholding contributes to the military member's uncertainty about his income tax obligation; it also makes payment of taxes more difficult and may increase the temptation not to file a tax return. If taxes were withheld, it would be clear that a responsibility to file existed; in the absence of withholding, it may be unclear what responsibility there is and there may be little incentive to find out. The physical distance between many military personnel and their domicile states where they should file returns complicates such things as information requests, taxpayer assistance, and auditing.

Current law further complicates state income taxes for military families stationed outside the state of domicile and having non-military income--e.g., property income, earnings from a civilian job of either the military member or the spouse--in that two states may be involved in the taxation of the family's income even though they may not be under civilian rules. For example, a military couple domiciled in Ohio and stationed in Kentucky with non-military earnings in Kentucky will have to pay Ohio taxes on military pay and Kentucky taxes on the other income. The necessity of filing and paying taxes in two states is an obvious complication; in the example given, but for the fact of military pay and the special tax provisions pertaining to it, reciprocity arrangements between the states would protect against having to file in both states. Such reciprocity is rather common at least in the Midwest and the East.

Joint filing arrangements also are made more complex. Most states require a joint return if a joint Federal return has been filed. In the case of a military couple having to file in two states with only part of the total income taxable in each, a complexity is introduced requiring special treatment (e.g., crediting or an exception to filing requirements) in recognition of the state tax status of military pay.

Viewed from the other side of the street, the same circumstances that promote inadvertent non-compliance or willful tax evasion complicate tax administration and enforcement. The W-2 information supplied pursuant to OMB Circular A-38 ostensibly tells state and local tax administrators who is claiming domicile or legal residence in their respective jurisdictions so that these officials know whom to contact, and where. The requirement for the military branches to obtain a declaration of legal residence is not stringent, however, and provision is made for W-2s to be sent to the state where a person is stationed if he does not declare a legal residence. The evidence (admittedly fragmentary) from the District of Columbia and Maryland follow-up effort reported above suggests that the W-2 information may be quite imperfect guidance to state and local tax officials--less than 30 percent of the sample for whom W-2s were received filed with the jurisdiction receiving the W-2. More on the A-38 process is in the next section.

Moreover, receipt of a W-2 is just the first step of a multi-phase process. First, the W-2s and tax returns must be matched, and the non-filers must be located and contacted. A possible outcome is that they will file, but another possibility is that they will inform the inquiring tax official that they filed elsewhere, or that domicile is claimed in a state

where military pay is not taxable. If either of the last two responses is given, thorough state tax administration would seem to entail contacting the state now named as the domicile state to (a) determine the validity of the claim and (b) let officials in that state know what has been learned so that any necessary follow up can be conducted by that state.

All this gets state-local tax administrators into the area of determining the validity of domicile claims--a process which may involve several agencies (e.g., motor vehicle registrars, election boards) and, because of the importance of intent, still be inconclusive. Considerable interstate, as well as intrastate and state-local, cooperation is necessary--the enforcement efforts of one jurisdiction will rely in part on the cooperation of other jurisdictions and on non-tax agencies.

Institution of withholding certainly would aid tax compliance and administration. Abandonment of the domicile-only jurisdictional rule now mandated by the Soldiers' and Sailors' Civil Relief Act also would facilitate administration and compliance, as well as improve tax equity.

Current Federal Arrangements to
Facilitate State-Local Taxation
of Military Pay Are Inadequate

Office of Management and Budget Circular A-38 was designed to aid state and local tax officials in the taxation

of all Federal employees, civilian as well as military, except for those serving overseas. It is specially tailored to the military tax situation only in that it does require the armed forces to obtain from each member a declaration of the legal residence, and to send a W-2-type statement to that state. The Circular further provides, however, that the wage statement should be sent to the state in which the military member is serving if there is no current legal residence declaration on file.^{37/} The Circular does not prescribe the form to be used for obtaining the declaration of legal residence, but the Department of Defense has settled upon use of the W-4 form (originally intended to show the number of exemptions claimed by a taxpayer) for this purpose.^{38/}

Aside from the Circular A-38 process, there are no Federal programs or provisions designed to help state and local tax officials cope with the administrative problems discussed above. Moreover, ACIR has learned that, in practice, the information supplied under A-38 often is of little value or, at best, can be utilized only at a high cost to the taxing agencies. The principal problems are:

- It is difficult to identify active duty military;
- Often, too few wage statements are received;
- Some of the wage statements received may be for non-domiciliaries;
- Many wage statements lack addresses; and
- Some services send wage statements in small quantities, from several sources, over a period of some weeks.

After casual discussion of the A-38 process with a few state tax administrators revealed a discrepancy between the number of wage statements for active duty military actually received and the number reported to ACIR by the military services as having been sent, a survey of the income tax states was undertaken in the early summer of 1975. The states were given the numbers of 1974 wage statements reported to ACIR by the services and were asked to verify the numbers. The responses often provided little information on this score, but were nevertheless quite revealing.

In general, states had trouble in identifying active duty personnel from civilian employees of the services, reservists, and others. In some instances, the number of wage statements received exceeded the number reported to ACIR by the services--perhaps because the state tax agency had been unable to sort out just the active duty military personnel--but in several instances the number of wage statements received fell short of the number reported to ACIR. One state, for example, reported that the Air Force had supplied the state with a list of 6,165 persons (compared with 7,139 reported to ACIR by the Air Force) while no 1974 wage statements had been received from the other services. Another state reported receiving 21,107 wage statements rather than the 25,692 reported to ACIR by the services. Wisconsin commented that, "Based on the figures supplied

by [ACIR] we have not received wage statements for all the active servicemen in any branch of the service."^{39/}

For the Army, for example, Wisconsin received only 1536 of 7,580 wage statements they were reported to have been sent for 1974.^{40/} More common, however, were responses stating the state's inability to determine just how many wage statements had been received for active duty military--often because of the identification problem already noted, but often because the state indicated that the information received under the A-38 process had proved to be of so little value that little or nothing had been done with the materials received for 1974.

Of the factors noted as limiting the usefulness of the wage statements, lack of an address was the most common. The several services apparently differ widely in this respect, however, if the Wisconsin experience is indicative. While the Air Force included addresses with all the wage statements supplied to Wisconsin and the Marines included addresses with 98 percent of the statements supplied to Wisconsin, addresses accompanied only 55 percent and 13 percent, respectively, of the statements sent to Wisconsin by the Army and the Navy.^{41/} Several states noted similar experiences (not broken down by service branch), and noted that the usefulness of a statement is very limited if there is no address. Moreover, an income tax official from one state noted that attempts to obtain addresses from the services subsequent to receipt of the

wage statements--an added round of letters and a step that should be unnecessary--yielded only a series of illegible labels.

Another problem with the A-38 process already touched upon is that the wage statement for an armed forces member is to be sent to the state where he is stationed if there is no declaration of legal residence on file. How widespread this problem is is not known; the District of Columbia and Maryland survey reported earlier, however, suggests that it exists to some degree. Two possible reasons for the wrong state receiving the wage statement are: (a) Circular A-38 does not require a serious effort to obtain a declaration of legal residence, but permits the service to send a wage statement to the state in which the person is stationed where no declaration is on file; and (b) there is no requirement that a specialized form be used in obtaining a declaration of legal residence and the Department of Defense has chosen to use a form designed for another purpose, which increases the possibility of confusion and error in the process.

Some states noted that the usefulness of the wage statements was restricted because they often are received in many small bundles rather than in a few larger batches (especially from the Navy, which is the least automated of the services in terms of its payroll operation) and because

computer tapes of the W-2 information often are not available (in spite of the provision in A-38 that computer tapes can be specified by the state and localities). Finally, A-38 pertains only to personnel--whether civilian or military--who are serving in the United States; overseas personnel are not covered. Because state income taxes often are applicable even when a person domiciled in a state is outside that state, the coverage of A-38 is narrower than the coverage of the taxes of many jurisdictions.

Revenue Loss and Tax Base
Erosion Are Consequences
of Current Federal Law

To talk of revenue loss requires some standard against which practice can be compared. The extent, causes, and solutions of the revenue loss problem will differ according to the standards used. One standard is current law (i.e., the Federal restrictions on state taxation of military pay). A second standard is the more logical circumstance that could exist if the differential treatment of military pay were ended.

Current Law.--Revenue loss under current law (domicile-only jurisdictional rule) is the difference between what actually is collected and what could be collected with perfect compliance with existing law. This concept of revenue loss is in one sense

an indication of imperfect tax administration, a matter requiring state-local action. No estimates of the current revenue shortfall are available (although individual states, working with state tax records, might be able to arrive at reasonable estimates); even greater estimation problems would be encountered in attempting to attribute the loss to Federally-caused difficulties versus tax administration because a significant part of the administrative problems of state-local tax officials stems from the Federal ground rules affecting taxation of military pay and failures to comply with these ground rules.

It is clear, however, that removal of the Federal prohibition against withholding would contribute to improved compliance and administration. Some early state studies of revenue gains due to withholding from the population in general placed the gain generally in the range of 10-15 percent.^{42/} The potential improvement in compliance due to withholding will vary, of course, with the quality and effectiveness of state income tax administration without withholding. For reasons already discussed, it may be reasonable to expect withholding to make more of an improvement in the taxation of military pay than in the taxation of the work force as a whole.

We have noted that the Federal statutes have the effect of encouraging states to erode their income tax bases

by exempting, in whole or in part, military pay. The cost of these exemptions in some degree may be attributed to existing Federal law, and these exemptions to increase the revenue loss figure.^{43/} Half the income tax states provided full or partial exemption of military pay for tax year 1974. The exemption issue remains unsettled elsewhere, with legislative bills to create new exemptions or broaden existing ones being introduced each year.^{44/} Under existing Federal law, further state income tax base erosion is probable.

No Differential Treatment of Military Pay.--If no distinctions were drawn between military pay and other income for determining state-local income tax liability first preference for taxation would go to the place of actual residence and/or where income is derived (i.e., a physical presence rule would govern). If more than one state established the right to tax (including the domicile state), a system of credits and reciprocal agreements would protect against double taxation. Withholding would apply to all types of earned income.

The revenue potential of such a system vis-a-vis the current system with domicile rules and military pay exemptions is the second standard against which to measure revenue loss. (Again, data limitations preclude placing a figure on this "loss" measure.) Alternatively, this measure may be viewed

as the current tax subsidy of military families by the rest of the population. The revenue "loss" measure is, then, one measure of the tax inequity resulting from current laws governing the taxation of military pay.

Reciprocal Agreements and
Credits Should Provide Adequate
Protection Against Double Taxation

When the possibility of changing the tax status of military pay to permit taxation by the state where the serviceman is stationed is raised, some express a fear of double taxation--taxation of the same military pay by both the domicile state and the state where the person is stationed. Such double taxation is undesirable and ACIR is opposed to it. Fortunately, the fear of double taxation is unfounded. Amending the Soldiers' and Sailors' Civil Relief Act to remove the provision that only the domicile state can tax military pay would, as noted earlier, simply make military pay subject to the same tax rules as other income. It would not create a new type of problem. In our mobile society, many people make interstate moves for a period of a year or two or three, and then relocate again. Some regard their moves as strictly temporary (no domicile change) while others treat them as "permanent" (domicile is changed). Still other persons regularly live in one state

and work in another, and thus become subject to taxation in two states. States already have worked out credit and reciprocity arrangements to protect persons in the circumstances just described from double taxation of the same income. All states with broad-based income taxes now provide a credit for taxes paid on earned income (at least) to other states by a resident of the state granting the credit.^{45/} While credits do not protect against the need to file in two states, they do serve to set a maximum tax liability no higher than the higher of the two states' taxes.^{46/} In addition, several states particularly in the Midwest and the East have entered into reciprocal agreements that offer even fuller protection, including protection against double filing on earned income. These provisions could--and would--apply to the military if the domicile-state-only rule were dropped.

Current Differential Tax Treatment
of Military vis-a-vis Civilian Pay
Is Not Warranted

The earlier sections point to the general conclusion that the current differential tax treatment of military pay causes problems of tax equity, compliance, and administration that could be avoided by a change in the rules to (a) allow taxation of military pay where living and/or stationed under the same jurisdictional physical-presence rules governing civilian pay and (b) authorize withholding of state-local income taxes from military pay.

With regard to the jurisdictional issue, the Soldiers' and Sailors' Civil Relief Act was adopted in 1940, at a time of mobilization for a major war effort, as a means of easing the transition from civilian life to involuntary military service. The 1940 situation no longer exists. Certainly a major difference is that service in the armed forces now is voluntary--military personnel are in the armed forces by choice.

Military compensation also has changed dramatically, especially in recent years. Between fiscal 1964 and 1973, for example, average "regular military compensation" increased over 100 percent.^{47/} "Basic military pay" rose even more rapidly, by 125 percent in the same period.^{48/} The current level of military compensation relative to civilian compensation is, of course, more important than the rate of increase. This comparison also is favorable to the military. Estimates show regular military compensation to be in excess of civilian compensation from the third year of service for officers with the differential growing larger, in favor of the military, from that point. The comparison for regular military compensation of enlisted personnel is not as favorable, however, but based on the broader measure of "total military pay" is estimated to be in excess of civilian personnel in virtually every instance.^{49/}

Table 3.3 shows military basic pay rates by rank, together with non-taxable cash allowances, after the October, 1974 pay increase. For comparison, 1963 (pre-Vietnam) basic pay by

rank also is shown. The percentage increases in basic pay over the decade range from 100 percent or less for generals bumped up against the statutory pay ceiling to as much as 350 percent for recruits and privates. Note, however, that because of the non-taxable cash allowances the pay ceiling for military has been more than 10 percent above the \$36,000 level applicable to Federal civilian employees. It is also worth noting that even the military recruit now is paid at a level above the minimum wage.

In the 1940s when the Relief Act was adopted, military service typically involved separation from family. With the family "back home" while the serviceman was away, the domicile-only jurisdictional rule made some sense as a means of financing benefits being provided to the serviceman's family. Any claim that this rationale remains valid simply is not consistent with the facts. Based on the data for 1972, over 98 percent of married military men stationed in the United States^{50/} are living with their wives. Counting all domestic forces (including those on board ships in domestic waters) 96 percent of military families are living together; even when all married military men are considered--regardless of where stationed--84 percent are living with wives.^{51/} Not only do virtually all military families now live together, the majority--70 percent of married military men--also live in private housing, off base, further weakening the civilian/military distinction.^{52/}

TABLE 3.3

Monthly Military Basic Pay, July 1963 and October 1974, and Monthly Non-Taxable Allowances and Total Annual Cash Pay and Allowances, October 1974, by Rank

Pay Grade	Title	Years of Service ^{1/}	MONTHLY MILITARY BASIC PAY			Monthly Non-Taxable Cash Allowances, 10/74 ^{2/}	Annual Total Pay and cash allowances, 10/74 ^{3/}
			July 1963	October 1974	Percent Increase 7/63 - 10/74		
E-1	Recruit	0-2	\$ 78.00	\$ 344.10	341	\$ 116.40	\$ 5,526.00
E-2	Private	0-2	85.00	383.40	351	116.40	5,997.60
E-3	Private 1st Class	0-2	99.37	398.40	301	116.40	6,177.60
E-4	Corporal	2-3	150.00	437.40	192	133.80	6,854.40
E-5	Sergeant	4-6	205.00	513.00	150	154.80	8,013.60
E-6	Staff Sergeant	14-16	275.00	702.30	155	166.80	10,429.20
E-7	Sergeant 1st Class	18-20	340.00	825.60	143	178.80	12,052.80
E-8	Master Sergeant	20-22	370.00	948.30	156	190.20	13,662.00
E-9	Sergeant Major	22-26	440.00	1,138.80	159	202.80	16,099.20
W-1	Warrant Officer	10-12	334.00	798.30	139	220.32	12,223.44
W-2	Chief Warrant	16-18	393.00	969.60	147	234.32	14,822.64
W-3	Chief Warrant	20-22	470.00	1,150.80	145	252.72	16,842.24
W-4	Chief Warrant	26-30	575.00	1,458.00	154	269.82	20,733.84
O-1	2nd Lieutenant	0-2	222.30	634.20	185	199.92	10,009.44
O-2	1st Lieutenant	2-3	291.00	798.30	174	235.92	12,410.64
O-3	Captain	6-8	440.00	1,161.00	164	256.92	17,015.04
O-4	Major	14-16	570.00	1,470.00	158	277.92	20,975.04
O-5	Lt. Colonel	20-22	745.00	1,821.30	144	302.52	25,485.84
O-6	Colonel	26-30	985.00	2,310.60	135	322.52	31,605.84
O-7	Brigadier General	26-30	1,175.00	2,630.40	124	354.42	35,817.84
O-8	Major General	26-30	1,350.00	3,000.00 ^{3/}	122	354.42	40,253.04
O-9	Lt. General	26-30	1,500.00	3,000.00 ^{3/}	100	354.42	40,253.04
O-1	General	26-30	1,700.00	3,000.00 ^{3/}	76	354.42	40,253.04

^{1/} Longevity pay step of typical military member.

^{2/} Non-taxable quarters and subsistence allowances for officers; quarters and clothing allowances for enlisted men (E-1 thru E-9) with dependents.

^{3/} Statutory maximum.

SOURCES: The Economics of Defense Spending: A Look at the Realities (Washington: U.S. Department of Defense, Assistant Secretary of Defense [Comptroller], 1972), Table 15-1, p. 132; 1975 Uniformed Services Almanac (Washington: Lee E. Sharff, 1975), pp. 9-15 and 23-26; and ACIR staff calculations.

A slight variant of the foregoing argument is that military families may wish to maintain their legal residence in a state other than where they are stationed for any of a variety of reasons--e.g., licensing for some occupations, filing and processing of wills, being able to send children to particular state colleges at instate tuition rates. There is some question, of course, as to whether such objectives warrant a Federal policy that strips states of the ability to tax military families stationed within their borders and currently receiving services from them. The problem is not unique to the military, but is shared by civilians who move among states. More to the point, however, is that taxes to the state where a person actually is living does not, at least by itself, cause a person to lose his domicile elsewhere.

Mobility of the military is a factor to be considered in weighing the appropriateness of the domicile-only jurisdictional standard. Clearly, military personnel are more mobile than the civilian population as a whole. In 1964 (before escalation of the Vietnam War), for example, 36 percent of married military men made an intercounty move compared with six percent of married civilians. During the height of the Vietnam War, the military mobility figure rose to about 50 percent in some years, while the civilian figure remained below seven percent.^{53/}

These aggregates may, however, overstate the problem of military mobility. For one thing, the military population is younger than the civilian population as a whole, and younger persons tend to be more mobile. The aggregates conceal variations in mobility among various parts of the civilian population. Some civilian occupation groups move frequently, although not "average," many business executives in the earlier stages of their careers make interstate moves every year or two.

More instructive of the potential difficulty of military mobility are statistics on the average length of duty tour. Data on average length of state-side duty tours by rank, supplied by the Army, show a range of about two years to three years.^{54/} Duty tours of this duration should pose no problems sufficient to justify continuation of the Federally-imposed domicile-only jurisdictional rule for state income taxation of military pay.

Finally, personal income taxes now are a much more significant state-local revenue source than they were in 1940. Between 1940 and 1975 the number of states using the personal income tax increased from 30 to 40,^{55/} and receipts from such taxes increased from 2.6 percent of state-local general revenue in 1942^{56/} to 9.5% in 1973.^{57/}

With regard to the withholding issue, the standard argument against withholding state-local income taxes from military pay is that the variation in these taxes would pose an unreasonable or even impossible burden on the armed forces. The Defense Department recently has attached a dollar figure to the task of withholding state taxes: \$9.9 million initial or start-up costs, then \$4.7 million annually.^{58/}

Automatic data processing techniques should make withholding quite manageable. Especially under current provisions, the mobility of military personnel really is not a factor; a change in domicile is the primary factor that would change the state to which taxes for a given person would be due. Changes in state and local tax codes would have to be followed and withholding changed accordingly, but this is not essentially different from the task faced by private companies (or by the military services for their civilian employees) operating in several states and localities.

With centralized payroll processing (which is to be universal among the services in a year or so), removal of the Relief Act's domicile-only jurisdictional rule might complicate the withholding process somewhat, but this should be manageable. A change of duty station already entails several records-keeping changes, including a change in where the paycheck must be sent. A change in the program to withhold for a different state's taxes at the time other changes are being made should be a manageable chore.

RECOMMENDATIONS

The foregoing sections have identified issues or concerns toward which the Commission may wish to address recommendations. These fit within two broad areas. The first is a jurisdictional issue, and is concerned with whether military pay should continue to be taxable only in the domicile state, or whether a physical presence rule of the sort applicable to other forms of compensation should now apply. The second general area of concern has to do with administrative and compliance matters--and particularly with changes that the Federal Government, and to a lesser extent state governments, could make to improve administrative and compliance aspects of state-local taxation of military pay. In general, the issues in this second area are separate from the first area--i.e., the decision made with regard to the jurisdictional issue does not alter the issues grouped under the compliance/administration heading.

1. The Jurisdictional Issue

Alternative A: Domicile. The Commission acknowledges that compliance and administrative problems currently exist with respect to state-local income taxes as applied to military pay, and it believes that improvement in this area is needed. The Commission concludes, however, that the circumstances associated with military personnel being absent from

their domicile states are sufficiently different from those associated with civilians absent from their domicile states as to justify different state income tax treatment for military active duty pay. Moreover, military compliance with state income tax provisions can be substantially improved without a basic change in the current jurisdictional rule. The Commission therefore recommends retention of the Soldiers' and Sailors' Civil Relief Act provisions stipulating that only the domicile state of a member of the armed forces may tax the military pay of that person.

This recommendation would preserve the status quo. The pro and con arguments are presented below.

Pro Arguments

The current domicile-only jurisdictional rule for state taxation of military pay has the major advantage of effectively precluding double taxation (taxation by two states) of military pay; moreover, this is accomplished without requiring the military member to file an income tax return in more than one state for his military pay.

Avoidance of double taxation of the same income is a widely shared objective, and an effective means of achieving this objective has been developed by the states, using credits and/or reciprocal immunities. This approach often requires the filing of tax returns in two states (especially in the

case of a credit, but also in the case of a reciprocal agreement if tax has been withheld for a state to which there is no liability)--the state of residence and the state where the income is derived. In many states, "resident" is defined to include a domiciliary. Thus, in the absence of the domicile-only rule, a military person domiciled in an income tax state and also stationed (and/or currently living) in an income tax state typically would, like other persons, have to file an income tax return in both states, even though he would not have to pay the (full) tax to both. Current Federal law spares the military the added complexity and bother of filing two state tax returns on military pay (although two returns still may be required if the military family has non-military income).

The Federally-mandated additional protection against double state taxation and even against double state filing afforded military pay is justified by the special nature of military service. Of crucial importance are the number of interstate moves and the circumstances under which they are made. Statistics presented earlier indicate that military personnel, as a group, are considerably more mobile than is the population as a whole. This means that the military person would be more likely to become subject to filing requirements in two states of employment or duty station within a

single year (in addition to his domicile state), and this would further increase his compliance costs if he were not protected from such multiple filing by the domicile-only provisions of the Soldiers' and Sailors' Civil Relief Act.

Some would counter that certain segments of the civilian work force are at least as mobile as the military. While this may be true, a crucial distinction between military and civilian workers is the involuntary nature of the reassignment of the military. A civilian worker, if he strongly wishes to avoid a geographic transfer, always has the option of resigning as a last resort. This recourse is not available to the military person whose term of enlistment is not up. Refusal to relocate can result in a court martial. The fact that persons in the military now are in the armed forces by choice removes only one involuntary element of military service--once in, the armed forces member has little control over where he is stationed.

The fear has been expressed that, given the mobility of the military, a change away from the domicile-only rule would present a risk that military personnel would become "nomads" with no "home state" where they could file their wills or be licensed for certain professions. This fear reflects the fact that one test state officials use in determining whether domicile has been established (or maintained)

is filing of state tax returns. In this circumstance, it is argued, payment of state income taxes to a state other than the domicile state could jeopardize a person's domiciliary standing in his home state.

Another advantage of the domicile-only jurisdictional rule is that it simplifies tax compliance for the military. Regardless of where the military person is stationed, he incurs an income tax obligation only in the domicile state. Thus, an interstate move does not require a person to become familiar with the tax laws of another state. Moreover, this stability of tax obligations minimizes the cost differentials (or take-home pay differences) associated with interstate moves. Changes in state income tax liability do not become a factor affecting a military person's satisfaction with a change of duty station.

Administrative considerations also favor a domicile rule, for reasons similar to those just given on the compliance side. State tax administrators have a more stable list of military taxpayers under the current rule than they would if military were liable for state income taxes where they are stationed. Also, if withholding of state income taxes from military pay were undertaken, this task would be simpler if the state in which a given military person owed an income tax did

not change every time his duty station changed. (This argument assumes complete centralization of military payroll processing, which is to be accomplished in the near future. In the absence of centralization, however, it would be easier to withhold on the basis of physical presence rather than domicile, since each duty station would have only a few state income tax laws to work with.)

An additional argument in favor of retaining the domicile jurisdictional rule for military pay is that this rule does not penalize states with relatively small military populations. Military personnel are drawn from all states, but military bases are concentrated much more heavily in some states than in others. If military personnel were to become taxable in the states where they are stationed, many states with light concentrations of military installations would lose revenues. The domicile rule spreads military income tax payments more uniformly.

Finally, to the extent that the state-local military tax problem is a compliance problem, it is not necessary to scrap the established domicile rule to solve the problem. The changes in Recommendation 2 would go far in resolving compliance problems.

Con Arguments

The arguments against the status quo are essentially

the same as the arguments in favor of the change recommended in Alternative B, including:

- The domicile rule produces many inequities in that states that rely on personal income taxes to fund state-local services are compelled to provide subsidies to non-domiciliary personnel because the states cannot apply the same jurisdictional rules to military pay that they apply to civilian pay;
- The domicile rule guarantees that state income tax inequities of a significant sort will exist as between non-domiciliary military personnel on the one hand and civilians and domiciliary military personnel on the other;
- The domicile rule encourages states to exempt military pay and thereby promotes erosion of state-local tax bases;
- The administrative/compliance advantages claimed for the domicile rule are not so compelling because, among other considerations, this rule provides a ready means of state income tax avoidance to the military member who is so inclined, and many military families currently have to file income tax returns in more than one state because they have non-military-pay income; and

-- The differences between military and civilian employments and life styles have steadily been diminished to the point that there appears to be no compelling justification for the Federal Government to dictate a differential state tax treatment for military pay.

Alternative B. Civilian (Physical Presence) Rule.

The Commission concludes that military active duty pay should be taxable under state personal income taxes according to the same jurisdictional rule as applies to all other forms of compensation. The Commission therefore recommends that Section 574 of the Soldiers' and Sailors' Civil Relief Act [50 U.S.C. Appendix Sec. 574 (1970)] be amended to remove the stipulation that only the service member's state of domicile or legal residence can tax his active duty military pay. The Commission further recommends that those states whose income tax laws now expressly exclude from taxation all or part of the active duty pay of military personnel who are not domiciled in the state act to remove such exclusions.

The first part of this recommendation would have Congress remove the Federal basis for the current differential tax treatment of military active duty pay as regards jurisdiction to tax. The second part of the recommendation would

have state legislatures remove from state income tax laws the exclusions of the military pay of non-domiciliary personnel that are now found in some states; at present, these provisions have no effect other than to codify in state law the Federally-mandated treatment, and this very likely was the primary reason for including such language in state laws. The thrust of the entire recommendation is to treat military pay the same as civilian pay. In short, first preference would go to the state in which the military member is physically present (working and/or living); the state of domicile, if different, might also assert its right to tax the military (and other) income of the member. The same crediting and reciprocal immunity laws that protect civilians against double taxation also would apply to the military. Pro and con arguments follow.

Pro Arguments

The state-local military tax problem emphatically is not simply a compliance problem. Equity is a central issue, and improved equity is the primary argument in favor of bringing military pay under the same state-local income tax jurisdictional standard as civilian pay. Examples earlier in this report demonstrate that the current jurisdictional rule produces many inequities. The equity gains that could

be achieved by changing the rule from solely a domicile standard to a physical presence standard are of two basic types: intergovernmental and interpersonal.

In mandating a domicile rule for state-local taxation of military pay, Congress has also mandated a system of intergovernmental subsidies. Some states (and their localities) are put in a position of being undercompensated for services provided to the military while others are in a position of being overcompensated. States with more armed forces members domiciled in them than actually present in them may be able, absent compliance and administration problems, to receive tax payments from military personnel in excess of the costs imposed on such states by military personnel, while states with fewer military personnel domiciled in them than are actually present within such states' borders are unable to collect income taxes commensurate with the costs of services enjoyed by the military.

Intergovernmental inequities result from individual inequities: some persons are paying taxes to jurisdictions from which they do not receive services, and other persons are receiving services from jurisdictions to which they do not pay taxes. But even if each state collected as much from its domiciliaries absent from the state as it has to forego (because of the Federal rule) from the non-domiciliaries

present within its borders, it would not automatically follow that there were no inequities or no problems. The basic situation would still exist in that some taxpayers would be paying for services that they did not receive while others were receiving services for which they did not pay. This situation causes taxpayer discontent and other problems.

It is understandable that a military person might feel unfairly treated if he has to pay an income tax to a state in which he no longer lives and in which he has no dependents. It is just as understandable that a civilian family (or a military family domiciled in the state) living next door to a non-domiciliary military family might feel that there is something unfair about a tax system that requires the civilian to pay income taxes to the state government that provides services for both the civilian and military families while this tax is not collected from the military family. These inequities would be just as apparent even if, at the state level, the net subsidies were zero.

The fact that a zero net subsidy is highly unlikely makes the interpersonal inequities all the more a problem. A state with a heavy concentration of military personnel stationed within its borders will have to collect more taxes from civilians and domiciliary military personnel and/or provide a lower level of services because of the non-taxability of non-domiciliary military persons' military pay.

In short, the change in jurisdictional standard recommended in Alternative B would improve equity by (a) ending the Federal mandate for a state-local subsidy to military personnel stationed outside their domicile states, (b) requiring military personnel to pay taxes to the jurisdiction in which they are physically present and receiving services, which would result from (c) subjecting military pay to the same state income tax jurisdictional standard that applies to civilian compensation.

Implementation of Alternative B also would end one Federal inducement or encouragement to state and local governments to exempt military pay from their income taxes. It was argued earlier that the domicile-only standard has encouraged two types of military pay exemption. One is the exemption of all military pay attributable to service outside the state, a move that can be supported on the basis of either or both of two considerations: (a) personnel stationed outside the state are not currently receiving state services, and (b) it is more difficult to collect an income tax from persons who are outside the state (especially in the absence of withholding). As of tax year 1974, three states had adopted such exemptions, and six had opted for the full exemption of all active duty military pay. The rationale for full exemption, in addition to the above, is that if only domiciliaries can

be taxed when stationed in the state while their non-domiciliary colleagues cannot be taxed, there appears to be discrimination against the "home folks." Such exemptions are, of course, tax base erosion. They may constitute an opening wedge by giving other groups--such as police and firemen--an issue upon which to seize and to argue for their own exemption on the ground that they, too, are "different" and deserving of differential tax treatment. The change in domicile rule recommended in Alternative B would undercut the arguments for military pay exemptions and thereby eliminate one source of state-local tax base erosion.

A third argument in favor of the change in jurisdictional standard is that the domicile rule facilitates tax avoidance by those who are inclined to minimize their tax burdens; this form of avoidance is not available to civilians because they are subject to a physical presence jurisdictional rule. By changing his domicile to a state with no income tax, or to an income tax state that exempts military pay, a service person has the ability to avoid paying any state income tax. The jurisdictional change recommended in Alternative B would close this loophole.

The change in jurisdictional standards also would facilitate both compliance and administration, in part because of a diminution in the physical distance separating taxpayers

and tax administrators. While many aspects of taxation can be carried out well irrespective of distance, such things as taxpayer assistance and auditing are better carried out at closer range. The change in jurisdictional rules would further assist tax administration by making the matching of state and Federal personal income tax returns more productive in the case of military taxpayers. As things now stand, many military file their Federal income tax returns from their current addresses, which typically are not their domiciles, while others file Federal taxes from an address in their domicile states; only the latter are very helpful to state tax officials under the current jurisdictional rule, and the former can be downright misleading and counterproductive.

An alternative approach to achieving the Federal tape-match advantage has been suggested by some--namely, amend the Federal Form 1040 to require each taxpayer to indicate in a separate space any state, other than the one shown in the address on the return, to which the taxpayer has a state income tax obligation. Assuming that persons know their state tax obligations, this change would indeed be beneficial; and, in the event that a taxpayer does not know clearly what his state tax obligations are, the appearance of this item on the Federal tax return might stimulate an inquiry. Civilians currently may have a tax obligation in more than one state, and military

personnel would in certain instances if Alternative B were adopted, so that the listing of two states on the Federal return could prove useful in the cases of both civilian and military taxpayers.

Critics of the jurisdictional change argue that it would complicate state income tax compliance for the military by making an individual's military pay taxable in two states --as is now the case for civilian pay--if the domicile state has an income tax and a domicile jurisdictional rule and the state where the person lives and/or derives income is different from the domicile state and also has an income tax. The jurisdictional rule change undeniably would cause some military persons to come under the jurisdiction of more than one state income tax for the first time, but this would not be the case for many of the military. One large group that would not be so affected consists of those either domiciled or stationed in a state with no personal income tax or an income tax state that continues to exempt military pay. Another group of military, however, would not become newly subject to filing requirements in more than one state because they currently are subject to such multiple-filing requirements. The Soldiers' and Sailors' Civil Relief Act applies only to active duty military pay; any other income of a military member or the spouse of

such a person is subject to civilian domicile rules. In short, the current jurisdictional rule can protect a military family against double taxation or double filing only insofar as military pay is concerned; military families (or single individuals) with other income already may be subject to multiple filing requirements. Moreover, the compliance problems faced by the military in this group are more complex now than they would be under the proposed jurisdictional change. The added complexity of the current situation is reflected in part by the fact that each of the two state income tax returns that may be required report different amounts of income (only the domicile state return will include military pay); exclusion of military pay from the tax return filed with the state where the military family currently lives and/or works may also affect a couple's ability to file joint state income tax returns.

Placing military pay under the civilian-type jurisdictional standard would, therefore, affect different persons differently. For some, there would be no change. For others, state income tax filing would be simplified. And for others the necessity of filing two state income tax returns would arise. For this third group, the change would involve greater complexity. At least three points need to be made in this regard: (1) the added complexity may be viewed as a reasonable price to pay for the greater equity of the tax system;

(2) the change would merely place military and civilian compensation on the same basis rather than treating either one differentially; and (3) states have provided a system of credits and/or reciprocal immunities to assure that double filing does not mean double taxation.

A final administrative consideration with regard to the change in jurisdictional standards concerns withholding of state-local income taxes from military pay. When all military services have completely centralized their payroll processing, the current domicile rule would be somewhat easier for the services to administer because a change of duty station would not entail a change in withholding. Nevertheless, withholding under the civilian rule as proposed in Alternative B would present problems of a modest proportion that certainly would not be insurmountable or even unduly costly. There would have to be a subroutine for each state income tax in the withholding program, and when a military member was transferred the withholding code in his payroll record would be changed--at the same time that other changes, such as location to which the check is to be sent, were being made. At present, centralized payroll processing does not exist for the Navy and the Army. Under these circumstances, the civilian rule would be simpler administratively since each duty station would have to work with only a few state income tax laws (rather than, potentially, all of them).

In response to the argument that abandonment of the domicile-only tax rule would make military personnel nomads, it should be noted that the proposed change simply would impose the civilian rule on military personnel--not a new and untried system. Moreover, payment of state income tax is not the only test of domicile. More to the point, a person does not lose his domicile status just because he pays an income tax to another state where he derives income--although filing in two states may be necessary in such circumstances.

A final argument in favor of the jurisdictional change is that there is no compelling reason for the Federal Government to mandate the differential state-local income tax treatment for military pay. The circumstances which existed in 1940 when the Soldiers' and Sailors' Civil Relief Act was passed no longer exist. In 1940, the country was embarking upon a large-scale war mobilization. Service was a hardship in terms of involuntary service via conscription, low pay, very frequent changes in duty station, and long separations from families. In recent years, however, the United States has established an all-volunteer armed forces system and has sharply increased the level of military pay. Military life no longer differs as much from civilian life in other respects, either, as

evidenced by statistics (given earlier) showing that (a) the average length of a state-side duty tour is between two and three years, (b) over two-thirds of married military personnel live in private housing off base, and (c) virtually all married military men are accompanied to their duty stations by their families rather than being separated from them. In short, military duty is much more similar to civilian employment now than in the past, and it seems appropriate to bring the two even more closely together by applying the civilian-type state income tax jurisdictional standard to military pay. Especially when one considers that such additional hardships as do remain for military service are now entered upon voluntarily, a clear justification for the Federal Government's shaping state-local income tax policy to the extent involved in the Soldiers' and Sailors' Civil Relief Act no longer exists.

Con Arguments

The arguments against dropping the domicile rule for determining state jurisdiction to tax military pay in favor of application to military pay of the civilian-type physical presence rule are essentially the same as the arguments in favor of the status quo, including:

- The domicile rule effectively precludes double taxation of military pay, and does so without the need to file two state income tax returns covering military pay, whereas the physical presence rule would require some military families, for the first time, to file state income tax returns in a second state;
- The physical presence rule would weaken a military person's ties to his domicile state and increase the risk of his becoming a "nomad";
- The physical presence rule would subject military personnel to different levels of state-local income taxation in different duty areas, interrupting the stability of income tax obligations (this is part of the general argument that military are sufficiently different as to justify Federally-mandated differential state-local income tax treatment); and
- The physical presence rule would not spread the state income tax payments of military personnel as evenly among the states.

Underlying many of these arguments against the physical presence rule and in favor of the domicile rule is the notion

that it is in some sense good not to have military personnel pay income taxes where they are living, working, and consuming services--or at least that it is not bad to have a Federally mandated subsidy for non-domiciliary military personnel. One explicit argument to this effect attacks the notion that there is a subsidy, noting that even though the military families may not directly pay the same taxes as other residents of the host area, the presence of a military installation is generally viewed as a desirable thing. This argument is buttressed by community efforts to obtain government installations, and to retain them once they have been established. The latter point--that community spokesmen do seek to obtain and retain government installations--can be granted without granting the inference that, therefore, it is all right for employees attached to the installation not to be subject to state and local taxes of the host jurisdiction. Communities also seek to obtain and retain private employers. But just because a community does not wish to see a General Motors plant, for example, closed does not mean that community leaders believe that GM employees should not contribute to services provided for their benefit.

2. Federal Changes to Facilitate
Administration and Compliance

The several alternative forms of Recommendation 2 present progressively more significant changes that could be made by the Federal Government to enhance state income tax compliance and administration as these taxes relate to military personnel. Each alternative version builds on the one preceding it, and the alternatives are viewed as being mutually exclusive. It would be possible, of course, to construct other alternatives. It should be reiterated that Recommendation 2 does not depend upon the decision taken on Recommendation 1.

Alternative A. Status Quo. The Commission believes that the Federal Government has an obligation to take all reasonable steps to assist armed forces members to meet their state-local income tax obligations, and a similar obligation to assist the states and localities in collecting such taxes from military personnel. Based upon a review of state-local income taxation of military pay, the Commission concludes that the Federal Government has taken appropriate and adequate steps to discharge these responsibilities. The Commission therefore recommends no additional steps be taken by the Federal Government toward this end.

Pro Arguments

The arguments in favor of the status quo are essentially the same as the arguments against the specific changes recommended in the following alternatives. In general, however, the support for the status quo consists of an assertion that the OMB Circular A-38 process is working well and is adequate, and that there is no need for withholding of state-local income taxes from the military (or, alternatively, that the prospective benefits are outweighed by the costs)--i.e., that there is no problem with military compliance with state-local taxes sufficient to justify additional actions on the part of the Federal Government to improve compliance and administration.

Con Arguments

Again, the reader is referred to the argumentation for the other alternatives under Recommendation 2. Arguments against the status quo are the arguments in favor of the changes contained in those alternatives. In general, the arguments against the status quo assert that there is a military compliance problem that could be lessened to a significant degree through implementation of withholding, availability to state tax administrators of an effective delinquency collection procedure, etc.--in other words, by permitting military personnel and state income tax administrators to use

the same procedures in connection with taxes on military pay that are available in connection with taxes on civilian pay.

Alternative B. Minimum Changes. The Commission believes that the Federal Government has an obligation to take all reasonable steps to assist armed forces members in meeting their state-local income tax obligations and a similar obligation to assist the states and localities in collecting such taxes from military personnel. Based upon a review of state-local income taxation of military pay, the Commission concludes that the Federal Government must take additional actions to effectively meet these obligations. The Commission therefore recommends:

- That the Office of Management and Budget amend Circular A-38 to (a) require a separate form specifically designed to obtain from military personnel a declaration of legal residence for tax purposes; (b) require that records of legal residence be kept current through annual updating;

(c) provide a code to identify active duty military personnel on the wage statements sent to state and local tax administrators; and (d) add personnel stationed overseas to those covered by A-38. In addition, the Commission recommends that the following two requirements of Circular A-38 be made operable: (a) the requirement that an address, and all other information normally found on a Federal W-2 form, be supplied for each person under the A-38 process; and (b) the provision that the wage statement information can be obtained on a magnetic tape if the state or local agency so requests.

- That the Congress instruct the Department of Defense to authorize voluntary allotments for payment of state or local income taxes for any armed forces member requesting such allotment. Allotment payments should be paid to the appropriate jurisdiction on a quarterly basis, with an annual reconciliation or total similar to a W-2 at the end of the calendar year.



-- That the Congress instruct instruct the Internal Revenue Service to add to Federal personal income tax Forms 1040 and 1040A a line on which the taxpayer would be required to indicate the state in which he maintains domicile or legal residence if different from the State in the taxpayer's address from which the return is filed.

Pro Arguments

The primary reason for making changes of the sort set forth above is that, under current arrangements, members of the armed forces have difficulty understanding their state-local tax obligations and otherwise experience difficulties in meeting these obligations, while state tax officials similarly experience difficulties in learning who among the armed forces members should be paying taxes to their particular states. The net result is a compliance problem. Mr. W.A. Barnes, Chief of the Income and Sales Tax Divisions of the Mississippi Tax Commission, has stated that, in spite of the efforts by the military services to inform their members of their state tax obligations (efforts which Barnes commends), ". . . my limited but factual survey reveals that states, on the average, have not reached the 50% level of compliance on the part of

military personnel."^{59/} Minnesota, for example, as noted earlier, received only one-third as many 1974 income tax returns from military personnel as the number of military personnel domiciled in Minnesota, according to the A-38 wage statements. In addition, data from the District of Columbia and Maryland survey (presented earlier) attest to the existence of a compliance problem.

The changes suggested in Alternative B of Recommendation 2 all would assist military personnel and/or state-local tax administrators in the payment and collection of state-local income tax obligations on military pay. They represent a minimum effort on the part of the Federal Government toward this end short of full withholding.

In the absence of withholding of state-local taxes from military pay and the problems that now exist in using Federal income tax tapes where the military are concerned to obtain a list of taxpayers, the annual wage statements to be filed with state and local tax administrators pursuant to OMB Circular A-38 represent virtually the only potential source of a realistic list of state-by-state military personnel with an income tax obligation. There are many problems with the A-38 process, however, which have greatly diminished its potential usefulness.

To obtain an accurate declaration of legal residence for tax purposes from each member of the armed forces, a form designed specifically for this purpose should be used. Currently, the services use the Federal W-4 form for this purpose. The W-4 was designed to obtain a statement of the number of exemptions to which a taxpayer is entitled, and includes no mention of legal residence. To make it clear to the service person filling out a W-4 that he is declaring his legal residence for tax purposes requires modification of the form and provision of specific instructions. This is not always done. The result is that a person's wage statement may be sent to a state that is not that person's legal residence. This may cause the tax administrator who receives the wage statement to needlessly (and inappropriately) follow up with the person to get him to file an income tax return. This sort of confusion and wasted effort could best be avoided, or at least minimized, by use of a special form for obtaining a declaration of legal residence.

Because a service member may change his legal residence, all service members should [annually] complete a new declaration of legal residence so that the filing of the wage statements with state and local tax administrators will be as accurate as possible. The Air Force is said to have implemented a procedure

for keeping records current by printing the domicile state semi-annually on each member's leave and earnings statement and asking the members to verify the correctness of the indicated domicile. Periodic updating of this information therefore appears feasible.

A further change in the A-38 process that would be helpful would be to require specific identification of active duty military personnel by code or some designation on their wage statements. State tax administrators report that they frequently have difficulty identifying active duty personnel, because they receive wage statements for civilian employees as well as military personnel, and also for reservists and retirees. The desirability of identifying the active duty personnel stems from the differential tax treatment of active duty pay pursuant to both Federal and state statutes.

Finally, A-38 should be changed to require the filing of wage statements for employees--civilian and military--currently serving outside the United States. State income taxes frequently apply to domiciliaries regardless of where they may be living at a given time and regardless of where their incomes are derived. Clearly, then, the A-38 process fails to provide pertinent wage information for one group of state-local taxpayers. This shortcoming initially complicates

matters for tax administrators. Ultimately it also works to the disadvantage of a person working overseas because it increases the likelihood that he will become delinquent in his state-local income taxes and eventually be faced with a very large unpaid tax bill, and possibly penalties for not filing. There appears to be no valid reason for not extending a system of state-local tax information returns to a group of Federal employees simply because they currently are working outside the country. So long as income tax laws are applicable to overseas employees, the income information statements should be available to tax administrators.

Better and more universal adherence to certain existing requirements of Circular A-38 also is desirable. A common criticism voiced by state tax administrators is that large numbers of wage statements received from some of the military services include no addresses, even though A-38 requires that an address be given for each person. The Wisconsin Department of Revenue, for example, reports that only 55 percent of the 1974 wage statements received from the Army and 13 percent of those from the Navy included an address. Moreover, the number of wage statements received was significantly below the level indicated by the Pentagon.

Lack of an address gives a state little to go on in attempting to locate an individual. Moreover, one state indicated to ACIR staff that, upon writing to the services to obtain addresses to go with names, illegible labels were received in return. Such shortcomings mean that A-38 is providing information that often is of little use, or that can be used only at inordinate expense to the tax administrators.

Another shortcoming in the implementation of A-38 concerns the form in which the wage statements are available from some of the services. Although A-38 indicates that the tax departments may elect to receive the information on magnetic tapes rather than on individual forms for each service member, tapes apparently are not available from some services. The implementation of centralized payroll systems for each branch of the armed forces, to be complete in the near future, should make use of tapes feasible. (Apparently the greatest difficulty to date has been with the Navy, which is the least centralized in its payroll system.) Several states have noted that receipt of the wage statements in very small and numerous bundles of individual forms, together with the shortcomings noted above, further diminishes the usefulness of the A-38 process at the present time. The computer is a standard part of state income tax administration, and availability of the

A-38 wage statements on computer tapes would be of great benefit to the states. Moreover, it should soon be feasible for all services to provide the information in this form, and probably with no increase in administrative costs--and possibly savings--to the services.

Finally, ACIR has learned through surveying the states that many states have not received as many wage statements for active duty military personnel as they should, according to figures supplied by the individual services to ACIR. If a state does not receive any wage statement for some of the military personnel domiciled there, then the A-38 process obviously cannot fully realize its potential for assisting state-local income tax administrators. The case for rectifying this shortcoming is self-evident.

Absence of withholding of state-local income taxes from military pay denies the military members the convenience of pay-as-you-go income tax payments and makes it necessary for them to pay in annual or quarterly lump-sums, often entailing the filing of quarterly declarations. This clearly makes it more difficult for a military member to meet his state-local income tax obligation; withholding is available to virtually every other class of worker. The basis for

denying withholding from military pay at least up to now has been the argument that withholding would impose excessive costs on the military services. If withholding continues to be denied, the least that the services could to assist their members in meeting their state-local income tax obligations is to authorize voluntary allotments for this purpose. Allotments are available for a variety of other purposes, including payment of insurance premiums and making deposits into savings accounts. The mechanics of the allotment therefore would seem to pose no insurmountable problems for the services. The allotment process would make it possible for members wishing to make periodic payments toward state and local income taxes to do so through the convenience of payroll deductions. This would help make up for the lack of withholding and would, therefore, assist both the military members and the state-local tax administrators.

The final ingredient of the "minimum change" package represented by Alternative B of Recommendation 2 is the addition of a line to Federal personal income tax forms for the purpose of obtaining from each taxpayer--civilian as well as military--a declaration of his state of domicile or legal residence, if different from the one shown in the taxpayer's address. This information could be recorded on the Federal income tax tapes

and would make the tapes much more useful to state and local income tax administrators by identifying a taxpayer's domicile state. Given the importance of domicile in the taxation of military pay under current law, the addition of this information would be particularly beneficial in connection with military personnel. Its usefulness would extend beyond the military, however, to include civilians who file their Federal personal income taxes from addresses different from their domiciles--including business addresses of partnerships in areas near state lines, as well as residence addresses where a person is temporarily away from his permanent or legal residence. The additional bother to the taxpayer would be negligible, and IRS processing costs also would be small. The advantages of this additional information, then, would appear to outweigh the costs of obtaining it.

Con Arguments

The basic argument against the recommended changes in the A-38 requirements and procedures is that the results would not justify the added costs. Asking each and every member of the armed forces to fill out another form declaring his legal residence for tax purposes clearly would involve some costs, both in collecting and storing the information. Updating this information annually would only add to the burden. Moreover,

annual (or other frequent) updating of the declaration of legal residence might have the undesirable effect of suggesting to military personnel that changing domicile is easier than it actually is; to legally change domicile requires the taking of certain actions, but an annual updating of the domicile declaration might give the impression that changing the state shown on the form is all that is needed to change domicile. If this belief developed, in spite of the services' best efforts to educate and assist, the implications for military compliance with state-local income taxes would be quite adverse.

The other suggested changes in the implementation of the A-38 process may be viewed as the state-local tax administration tail wagging the military payroll processing dog. Providing magnetic tapes with the wage information is the prime example of this, particularly because some of the services, up to now, have not automated their payroll operations. If the individual wage statements must be collected and the information entered onto computer tapes via a separate process, strictly for the purpose of providing data for state-local tax officials, the responsibility for this separate process should rest with the tax administrators. This is especially true since different states use different computer systems and therefore would impose somewhat different processing requirements on the services.

The voluntary allotments approach to meeting state and local income tax obligations also would entail increased records-keeping costs for the military services. Presumably, the payments would have to be made to the tax departments using specified forms very comparable to employer withholding income tax returns, and would also involve use of an annual statement provided to the employee for use in filing his income tax return showing the amount of taxes paid under the allotment system. In short, the allotment system would involve many of the administrative procedures of withholding (except that the service member would determine the amount to be withheld under the allotment), but it would not provide all the benefits of a withholding program. The allotment would assist tax administrators in collecting taxes only from those who voluntarily asked that the interim payments be withheld from their pay. To the extent that military personnel seek to avoid making tax payments, voluntary allotments will be of no assistance. Installation of an allotment system might also delay the eventual adoption of withholding.

Inclusion of a separate line on the Federal income tax forms would add further complexity to an already complex situation. The full extent of the complexity is not reflected by the statement that "one more line" would be added. The notion of domicile is not a very easy one to explain, and

differences of opinion as to whether domicile has been established or relinquished often exist. To ask the taxpayer to indicate his domicile state on his tax return and then to swear to the correctness of his statement clearly would add a point of confusion and anxiety to the process of income tax filing for many people, at least the first time it was encountered. The need for domicile data is obvious when states assert jurisdiction to tax on the basis of domicile, but the need to complicate every Federal income tax return with the concept of domicile is not particularly compelling. The needs of the states and localities would seem to be best served by modifying the A-38 procedures as described above to handle the military situation, and continue to handle the cases of civilians in the manner currently in use.

Alternative C. Significant Changes. [Same as Alternative B, plus the following.]

-- That the Congress adopt legislation waiving Federal immunity from state court actions to the extent necessary to make feasible wage garnishments of military pay and Federal civilian pay for delinquent state or local income taxes. Such legislation should explicitly instruct the Federal agencies to accept and act upon court orders in such cases.



Pro Arguments

Establishment of this sort of delinquency withholding (actually a wage garnishment) would enable state and local tax administrators to collect delinquent income taxes from Federal civilian and military personnel in the same manner that they do from employees in the private sector. Once a Federal employee has become delinquent in meeting his state-local income tax obligations, the Federal Government has a moral responsibility to the states and their localities to lend reasonable assistance in the collection of back taxes; this is especially true in the case of military pay, where the Federal Government has not seen fit to extend the withholding system for current taxes. It is unseemly for Federal employees to be able to ignore with impunity court orders to pay legitimate tax obligations to subnational governments. Such willful tax evaders should not be protected by the doctrine of Federal immunity from state court actions. It should be noted that Federal income tax notices of levy frequently are asserted against state and local employees.

There is precedent for waiver of this Federal immunity. P.L. 93-647 requires Federal agencies, including the military services, to comply with court orders to enforce alimony and child support awards by withholding such payments from the pay of Federal employees. The case for supporting court

orders concerning delinquent state and local income taxes is at least as strong as the case for supporting such orders concerning alimony and child support. Taxes to support governments constitute a very high obligation that have a status in law well ahead of numerous situations involving private obligations and private hardship. Clearly, a waiver of Federal immunity to enforce tax judgments is justifiable.

Con Arguments

Federal immunity is not a matter to be treated lightly. Waivers of immunity should be made only in special circumstances and within carefully prescribed bounds. The situation with respect to alimony and child support is qualitatively different from the state and local income tax situation. Unpaid alimony and child support payments directly and significantly affect the lives and well-being of the intended recipients of such payments. Unpaid state and local taxes, on the other hand, remove only a small fraction of the revenue of the taxing jurisdiction; the diminution of revenue is not such as to immediately and significantly jeopardize the welfare of any identifiable person. Under these circumstances, then, it is best to regard delinquent state-local income taxes as a matter that is between the taxing jurisdictions and the individuals involved. Particularly in the case of Federal civilian employees, where current withholding of state-local income taxes is the rule, delinquencies should

not be a serious enough problem to warrant waiver of Federal immunity and incurring of the necessary administrative costs to carry out the wage garnishees for delinquent taxes.

Alternative D. Fundamental Changes. [Same as Alternative C, plus the following but less the allotment provision in Alternative B.]

-- That Congress amend P.L. 82-587 (governing state income taxes), the District of Columbia Revenue Act of 1956 (governing the D.C. income tax), and P.L. 93-340 (governing local income taxes) to require withholding of state and local income taxes from military pay. In this latter instance, military and Federal civilian employees should be considered jointly in determining whether the threshold of 500 Federal employees that triggers local income tax withholding has been reached.

Pro Arguments

Military personnel currently are the major exception to the rule of withholding for state-local income taxes. Thus, the military constitute the only large group of persons denied the convenience of pay-as-you-go payments of these taxes. To continue to deny this advantage to the military on the basis that withholding would be too costly for the Department of Defense due to the mobility of military personnel

is an untenable position, in part because the mobility of the military is the direct result of Department of Defense policy and actions.

At the same time that individual members of the armed forces would benefit from the convenience of withholding in meeting state-local income tax obligations, state-local income tax jurisdictions also would benefit from improved military compliance with their taxes and from the reduced administrative costs made possible by withholding in comparison with current procedures. There is a compliance problem, as demonstrated by data presented earlier in connection with Alternative B of Recommendation 2. A number of state studies have shown very significant increases in revenue from non-military taxpayers attributable to the improved compliance resulting from withholding.

Private employers must withhold state income taxes, as does the Federal Government for its civilian employees--including the civilian employees of the military services. With or without centralized payroll processing, and regardless of the jurisdictional standard, withholding from military personnel is feasible (see the pro argumentation under Recommendation 1, Alternative B).

That withholding would impose added financial costs on the military services is obvious. All employers bear

the costs of withholding taxes from their employees, although many might wish to escape from the costs imposed by this system. The services, as already noted, have estimated that it would cost \$9.9 million to gear up for withholding, and then cost \$4.7 million annually to operate the system. The annual cost is less than \$2.50 per military member and is a reasonable price to pay for increased convenience to the armed forces members and improved state income tax compliance and administration. The cost to the Pentagon of withholding is almost certainly lower than the cost the states would incur in trying to identify, locate, and collect from all military personnel under present circumstances. Thus, withholding probably would represent a net gain to the system as a whole. It is appropriate, moreover, that the Federal Government bear the withholding costs, not only because other employers must bear similar costs, but, because to the extent that taxation of the military entails certain unique difficulties, they are the result of Federal actions and policies.

The OMB Circular A-38 process for providing state and local tax officials with income information on military personnel has proved quite inadequate to date. Even if the A-38 process were improved along the lines recommended here, it would not be a really good substitute for withholding.^{60/} Provision of the wage statements under A-38 apparently was

envisioned by the promulgators of the circular as a supplement to withholding rather than a substitute for it, for the provisions of A-38 (first adopted in 1963) also apply to civilian employees of all Federal agencies (from whom state income taxes have been withheld since 1952).

Con Arguments

The arguments against withholding come down to the Department of Defense position that it simply would be too costly and too inconvenient for the services. The fact that each state has a somewhat different income tax structure is pointed to as a complicating factor which would necessitate preparation of numerous computer programs or subroutines. Also, the services would have to keep abreast of changes in state income taxes and make periodic changes in withholding programs. The Pentagon has estimated that withholding of state income taxes would cost \$4.7 million annually.

The Department of Defense also argues that the wage statements provided to state and local governments since 1963 pursuant to OMB Circular A-38 have not been used to their full potential by the states and localities. It is argued that more should be done with this source of information to improve compliance before asking the Federal Government to incur the added costs of withholding.

3. State Conformity to Federal Tax Base

Alternative A. Status Quo. The Commission is cognizant of the fact that many states tax military pay differently than the Federal personal income tax; principal among these differences are the partial and full exemptions for active duty military pay now found in about half the income tax states, and some differences in the definition and treatment of combat pay. While these differences are a major source of the differences among states that will complicate any attempt to withhold state income taxes from military pay, and while the state exemptions deviate from the principle of broad-based income taxation based upon ability to pay as evidenced by amount of income rather than source of income, the Commission believes that the matter of state tax base definition is best left to the states. The Commission recommends that state policy objectives continue to determine state tax base definition with regard to military pay, rather than having the states simply pick up Federal provisions in this area.

Pro Arguments

The defense of the status quo must be couched as an argument against base conformity for the sake of base conformity and in support of the right of the states to be independent in establishing tax policy. However, defending on substantive

grounds the variety of state provisions that represent the status quo is not possible in this report because of their sheer number and the complexities involved. But this does not mean present tax base definitions are ill-conceived or that the argument for individual state determination is weak. To the contrary, the sovereignty of the states in matters of taxation (subject only to the overarching limitations of the United States Constitution) is a very important and cherished principle.^{61/}

Alternative B. State Conformity to Federal Base. The several deviations of state income taxes from Federal provisions with regard to the taxation of military pay represent a major complicating factor in any attempt to institute withholding of state income taxes from military pay. Moreover, the partial and full exemptions of military active duty pay now found in about half the state income tax statutes deviate from the principle of broad-based income taxation based on ability to pay as indicated by amount of income rather than by source of income, and such deviations create inequities in the tax structure. The Commission recommends, therefore, that the states with income taxes amend their income tax statutes as necessary to bring state tax treatment of military active duty pay as regards inclusion in tax base into conformity with Federal treatment in all important respects, including the treatment of combat pay and coverage of basic military pay.

This recommendation is seen as a specific application of long-standing Commission policy made a decade ago, which the Commission now restates:

The Commission recommends that the States endeavor to bring their income tax laws into harmony with the Federal definition of adjusted gross income, modified to allow the deduction of individuals' income earnings expenses and for such additions to the tax base as considerations of base-broadening and equity make feasible.^{62/}

Pro Arguments

An obvious argument in favor of base conformity is simplicity and compliance ease. If military pay is taxable under state income taxes to the same extent that it is taxable under the Federal tax, understanding of state taxes would be considerably enhanced. This would be especially important to individual members of the armed forces if the change in jurisdictional rules discussed earlier were adopted, since in these changed circumstances interstate moves would mean changes in tax liabilities. Conformity of state provisions for taxing military pay, then, may also be viewed as the

minimum change a state should be willing to make to remove one of the obstacles to the jurisdictional rule change contained in Alternative B of Recommendation 1.

Base conformity also would facilitate state income tax withholding as suggested in Alternative D of Recommendation 2. If all states treated military pay in the same manner, and if that treatment were the same as the Federal, the burden on the military services to operate a payroll withholding system would be much lighter than under present circumstances.

Equally important, base conformity would have the advantage of improving the equity of state income tax systems because conformity to Federal provisions would mean elimination of the partial and full military pay exemptions. The source of income is unimportant in determining one's ability to pay; elimination of these exemptions would improve taxpayer equity. Nevertheless, some argue that the military deserve preferential tax treatment vis-a-vis civilians, and such persons would oppose elimination of the state exemptions on this ground. It is important to note, however, that simply picking up the Federal definition of taxable military pay incorporates some important exclusions from tax base--notably, the quarters, subsistence, and uniform allowances, which comprise a significant share of military income, are not taxable.

Any time a state adopts an exception to the principle of broad-based income taxation, it is narrowing (eroding) the base. The direct consequence of this is that persons not in this favored group must pay higher taxes and/or the services provided to all are lower than they otherwise would be. Thus, these exceptions to general applicability to tax laws create inequities. They also create resentment where they are understood, and fuel the efforts of others who would like to persuade legislators that they, too, are worthy of preferential tax treatment. Elimination of the military pay exemptions could help turn around the trend toward greater base erosion. This effort would be considerably aided, of course, by the change in jurisdictional rule discussed earlier in that such a change would remove a major form of Federal inducement to state-local income tax base erosion.

Con Arguments

As discussed in connection with the pro arguments for the status quo alternative, there is a good deal to be said for maintaining state autonomy in the definition of state income tax bases; this "states' rights" argument is a major consideration weighing against the conformity proposal.

Another and perhaps more practical consideration is that complete uniformity among the several states on detailed matters of tax policy is difficult, if not impossible, to achieve, regardless of the worthiness of the objective.

FOOTNOTES

1. Reference to Federal restrictions on state income taxation applies also to local income taxation.
2. 50 Appendix U.S.C. Sec. 574 (1970).
3. 66 Stat. 765-66; Ch. 154, 70 Stat. 68, March 31, 1956; and 88 Stat. 294, July 10, 1974, respectively.
4. 4 U.S.C. Sec 106 (1970).
5. All states but Connecticut, Florida, Nevada, New Hampshire, New Jersey, South Dakota, Tennessee, Texas, Washington, and Wyoming have broad-based state personal income taxes. See Advisory Commission on Intergovernmental Relations, Federal-State-Local Finances: Significant Features of Fiscal Federalism, 1973-74 Edition, M-79 (Washington: Government Printing Office, 1974), Table 96.
6. The focus is on active duty pay in non-combat zones. Special provisions (i.e., differing from Federal) for combat pay and retirement pay are not included in these figures.

Federal law excludes all pay for service in a presidentially-designated combat zone for enlisted personnel and up to \$500 per month for officers in determining Federal income tax liability; the same provisions pertain to pay drawn while hospitalized due to injuries sustained while serving in a combat zone. Pay for persons who are prisoners of war or missing in action also is exempt for the period of POW/MIA status. In addition, housing and subsistence allowances are not taxable.

Basic information of state income tax provisions relating to military pay is: All States Income Tax Guide, 1975 Edition for 1974 Returns (Washington: U.S. Air Force, Office of the Judge Advocate General; undated).

7. In six states (Maine, Missouri, New York, Oregon, Rhode Island, and West Virginia) a domiciliary stationed outside the state may have no tax liability to the state if he meets certain residency requirements, typically that the person (a) maintains no permanent place of abode in the state, (b) does maintain a permanent place of abode elsewhere, and (c) is in the state less than 30 days of the year. (Based on the All States Income Tax Guide.)

8. Ibid.
9. Pursuant to OMB Circular A-38, however, each state is to receive W-2-type information for each military member domiciled in the state (although the procedure is not working as effectively as it could). The OMB circular stipulates that the forms used, while containing W-2 information, are not technically W-2s and are not to be identified as W-2s. U.S. Office of Management and Budget, Circular No. A-38 Revised (Washington: OMB, March 25, 1974; processed), pp. 3-4. For convenience, these forms are called W-2s in this report.
10. Connecticut, General Assembly, Joint Committee on Legislative Management, Office of Legislative Research, "The Definition of 'Resident' in Selected States" (Hartford: Connecticut Office of Legislative Research; processed; April 13, 1971), p. 1, quoting Black's Law Dictionary.
11. Ibid., p. 2, quoting American Jurisprudence--Elections.
12. For summaries of the types of definitions, see: Advisory Commission on Intergovernmental Relations, Federal-State Coordination of Personal Income Taxes, A-27 (Washington: Government Printing Office, 1965), pp. 148-49; and Jerome R. Hellerstein, State and Local Taxation Cases and Materials, 3rd ed. (St. Paul: West Publishing Company, 1969), p. 618.
13. 50 Appendix U.S.C. Sec. 574 (1970).
14. Ibid.
15. All States Income Tax Guide, p. iii.
16. Connecticut Office of Legislative Research, "Definition of 'Resident,'" quoting American Jurisprudence--Elections.
17. P.L. 93-340, passed in 1974, extended withholding to include local income taxes on Federal civilian employees, except in cities having fewer than 500 Federal civilian employees, thereby bringing into the fold the other major group that had not been covered by withholding.

18. For example, H.B. 269 in the 1975 Hawaii legislative session and H.B. 5017 in the 1975 Rhode Island legislative session both proposed such exemption. State Tax Review for March 4, 1975 (p.3) and March 11, 1975 (p.12), respectively (Chicago: Commerce Clearing House).
19. In addition to the five states providing full military pay exemptions for tax year 1974 (see Appendix A and earlier section), H.B. 152 adopted in Montana in 1975 provides for full exemption of military pay under that state's income tax. [State Tax Review, April 22, 1975 (Chicago: Commerce Clearing House, p. 4).] Similar bills were introduced in other states, including New York (S.B. 1343 and A.B. 1274) and Wisconsin (S.B. 9). [State Tax Review for March 11, 1975 (p. 11) and for May 27, 1975 (p. 7), respectively (Chicago: Commerce Clearing House).]
20. Exempting military pay earned outside the state by persons stationed outside the state (and having no dependents in the domicile state) actually represents an improvement in tax equity by the benefits-received rationale of taxation, from the standpoint of the domicile state. But from the broader national perspective, such exemption diminishes equity by totally excluding some income flows from taxation.
21. In Ohio, for example, a 1972 bill that would have fully exempted military pay from the state income tax elicited testimony from spokesman for police and firemen--who assumed that the proposed military pay exemption was based at least in part on a public-service rationale--that police and firemen were at least as deserving of such preferential tax treatment as the military.
22. The Soldiers' and Sailors' Civil Relief Act accords the same treatment to personal property for non-domiciliary military personnel, so jurisdictions levying personal property taxes experience the same effect as those levying personal income taxes. Moreover, as discussed elsewhere in this report, other Federal laws and practices reduce military payments of sales and excise taxes.
23. Based on "Defense Personnel and Total Population in the United States by State as of June 30, 1973" (Washington: Department of Defense, OASD [Comptroller], Directorate for Information Operations, November 15, 1973).

24. In Maryland, counties impose piggyback income taxes, typically at 50 percent of the state tax. Thus, the counties and Baltimore City also would gain revenue if military pay were taxable in the same manner as civilian pay. Local taxes are not included in the estimate.
25. The number of military personnel present in Maryland is based on the Census concept (residence) rather than on the basis of location of the duty assignment (place of work); the number of military personnel residing in Maryland is greater than the number stationed at Maryland bases. Because the number of persons in the military has declined since 1970, the number of armed forces personnel in Maryland in the 1970 Census of Population (65,601) was reduced by 22 percent (the average decline in U.S.-based armed forces personnel between 1970 and 1974) to 51,169. Average basic pay (i.e., taxable pay) per military person in 1972 was calculated conservatively at \$7553, a figure which was adjusted upwards by 19.55 percent (to \$9030) to reflect the average increase in basic pay between 1972 and 1974-75. To this estimated taxable military pay level was applied an effective state income tax rate of 2.2 percent, yielding an average state income tax liability of about \$199. This figure, times the estimated number of military persons (51,169), produces an estimated aggregate Maryland state income tax liability for military personnel living in the state of \$10.2 million. The figures are imprecise because of the extensive use of averages; only a rough order of magnitude is indicated by the estimate. [Size of the Maryland military population is from U.S. Bureau of the Census, Census of Population: 1970, Vol. 1, Characteristics of the Population, Part 22 (Washington: Government Printing Office, 1973), Table 53; data on overall military strength in U.S. and military pay levels are from the Office of the Assistant Secretary of Defense (Manpower and Reserve Affairs and Military Market Facts Book: 1973 (Washington: Army Times Publishing Company, undated), pp. 67, 122, and 268; the 1972-1973 change in basic pay is between 1972 and 1974-75 is based on Office of Management and Budget data; and the effective tax rate information is based on ACIR, Federal-State-Local Finances, Table 139.]
26. Census Bureau, Characteristics of the Population, Part 48, Tables 34 and 121.

27. The OMB Circular A-38 procedure described in footnote 9 could provide considerable assistance in identifying taxpayers. Some shortcomings are noted later.
28. The figures for Maryland and the District of Columbia used in this section were supplied to ACIR by the District of Columbia Department of Finance and Revenue.
29. Circular A-38, p. 3.
30. Minnesota Department of Revenue submission to ACIR, July, 1975.
31. The 28,858 figure is the number of wage statements sent to Minnesota for 1974 for active duty members of the Air Force, Army, Marine Corps, and Navy, according to data supplied to the ACIR by the Office of the Assistant Secretary of Defense (Manpower and Reserve Affairs) in April and May, 1975.
32. W. A. Barnes, "Withholding of State Income Taxes on Wages of Military Personnel," paper presented at the 1975 annual meeting of the National Association of Tax Administrators (processed; June, 1975), p. 3.
33. In these states the same provisions apply to civilians. Other states have such provisions for civilians but do not apply them to the military because of the domicile-only rule pertaining to military pay.
34. Air Force, Marine Corps, and Navy data in Table 3.1 are simply tabulations of the state-by-state figures supplied to ACIR by the respective services through the Office of the Assistant Secretary of Defense (Manpower and Reserve Affairs). The Army, however, supplied figures on the number of wage statements sent under A-38 only for 38 states and the District of Columbia, so it was necessary to estimate the number of Army personnel claiming domicile in the other twelve states.

The basic relationship used in making the estimate was that between the number of personnel actually serving in the United States (50 states and D.C.) as of June 30, 1974 and the number of wage statements sent under A-38 (which does not cover overseas personnel) for 1974 (all data supplied by the Department of Defense). For the Air Force, Marine Corps, and Navy the ratios of wage statements to mid-year actual strengths were 1.25, 1.43, and 1.22, respectively. The simple average of these is 1.30, the weighted average, 1.26. It was assumed, therefore, that

the number of legal residence claims (wage statements) for the Army would have been 25 percent higher than the mid-year actual strength, had the Army kept records for all 50 states as the other three services did. The 25 percent figure used approximates the weighted average relationship for the other three services, is the figure indicated for the Air Force (which is perhaps more similar to the Army than are the other two services), and is more conservative than the simple average.

The number of legal residence claims for the 12 unreported states was gotten by subtracting from the estimated grand total (estimated as just described) the number reported for the other 38 states and D.C. The 12 unreported states fall into three of the six groups in Table 3.1--all 10 no-tax states in the first group, Vermont in the second group, and Rhode Island in the fourth group. It was estimated that these twelve jointly accounted for 44.9 percent of Army legal residence claims in 1974. Because all except Vermont and Rhode Island fall in a single group, and because Vermont and Rhode Island are small (0.7 percent of U.S. population in 1973), each of these two states arbitrarily was assumed to account for the same percentage of legal residence claims as their respective percentages of populations, thereby leaving 44.2 percent of the Army legal residence claims in the 10 no-tax states. The number of legal residence claims attributed to Vermont and Rhode Island could be made a multiple of their population shares without significantly reducing the general magnitude of the share of legal residence claims estimated for the no-tax states.

35. Calculated from: OASD(C), "Defense Personnel and Total Population in the United States by State, as of June 30, 1973."
36. Based on information supplied, in response to an ACIR request, by the individual services through the Office of the Assistant Secretary of Defense (Manpower and Reserve Affairs).
37. The provisions relating specifically to the military are in item 6a of the latest (March 25, 1974) version of Circular A-38.

38. All States Income Tax Guide, p. ii.
39. June 10, 1975 packet of materials pertaining to military wage statements sent to ACIR by the Wisconsin Department of Revenue.
40. Ibid.
41. Ibid.
42. As reported in Clara Penniman and Walter W. Heller, State Income Tax Administration (Chicago: Public Administration Service, 1959), p. 208.
43. Some part of the exemptions no doubt are for patriotic reasons not induced by Federal restrictions on state-local taxation. The partial exemptions, for the first one or two thousand dollars of military pay, seem more likely to fit this category than do the total exemptions or the total exemptions for domiciliaries stationed outside the state. Appendix A lists state exemption provisions for tax year 1974.
44. See footnotes 18 and 19.
45. State Tax Guide, 2nd ed. (Chicago: Commerce Clearing House), p. 1543 dated June 1975.
46. Federal-State Coordination of Personal Income Taxes, pp. 142-46, contains a discussion of crediting arrangements.
47. Military Market Facts Book, p. 125. Note that "regular military compensation" figures include quarters and subsistence allowances, which are not taxable, and the Federal income tax advantage of those allowances.
48. See Appendix B, Table B-3. "Basic military pay" excludes the non-taxable allowances and their attendant tax advantage. It is taxable money income only.
49. See Appendix B, Table B-1.
50. This group may be of special interest since, under a strict physical presence jurisdictional standard, persons not living in the United States would not have a tax obligation to the states.

51. Military Market Facts Book, p. 89.
52. Ibid, p. 84. The issue of on- or off-base housing is not critical to the taxation issue since (a) from an equity standpoint, many services funded by income taxes are available to persons who may not live in the private community; and (b) from a legal standpoint, the Buck Act extends the reach of state income taxes even to Federal jurisdictions.
53. Military Market Facts Book, p. 68
54. Data supplied in attachment to letter dated August 16, 1974 from former Secretary of the Army Howard H. Callaway to former ACIR Executive Director William R. MacDougall.
55. Federal-State-Local Finances, Table 96. (Hawaii is included in the 1940 figure.)
56. Ibid., Table 23.
57. U.S. Bureau of the Census, Governmental Finances in 1972-73, GF 73 No. 5 (Washington: Government Printing Office, 1974), Table 4, p. 20.
58. Estimate supplied in written submission to ACIR by Col. William A. McSpadden, Office of the Assistant Secretary of Defense (Manpower and Reserve Affairs), dated July 1, 1975.
59. Barnes, "Withholding of State Income Taxes on Wages of Military Personnel," p.3.
60. The fate of the Circular A-38 process apparently is unclear as a result of provisions of the Privacy Act. By the time the Commission considers this report on September 11 and 12, it should be known whether A-38 will continue or not since continuation of A-38 actions as a routine use of Federal payroll data would have to be advertised in the Federal Register prior to that time. If A-38 is abandoned, it is obvious that some of the recommendations contained in this report would no longer be appropriate. Moreover, loss of the A-38 vehicle for providing military payroll data to state and local tax agencies would significantly increase the case for withholding of state and local taxes from military pay.

61. For a discussion of this issue by state tax administrators, albeit in a different--and more global--context, see: Federal Collection of State Individual Income Taxes under Public Law 95-512, Report of the Special Committee of the National Association of Tax Administrators (Chicago: National Association of Tax Administrators, 1972), pp. 27-34.
62. Advisory Commission on Intergovernmental Relations, Federal-State Coordination of Personal Income Taxes, A-27 (Washington: Government Printing Office, 1965), p. 24.

APPENDIX A

SUMMARY OF STATE LAWS GRANTING TAX ADVANTAGES TO MILITARY PERSONNEL ^{1/}

Alaska:

All military pay exempt from state income taxation; military personnel also exempted from payment of state school taxes.

Arizona:

The first \$1000 of military active duty pay exempt from income taxation.

Arkansas:

The first \$6000 of military pay or allowances excluded from income tax.

California:

First \$1000 of military pay excluded. Also, California residents in military who leave California under permanent change of station orders become nonresidents for income tax purposes, taxable only on income from California sources (under community property law, however, one-half of military pay from service outside California would be taxable in California if spouse remains there).

Idaho:

Military pay not taxable if stationed outside Idaho.

Illinois:

Military pay not taxed.

Indiana:

First \$2000 of military pay excluded.

Iowa:

Military pay not taxed.

Maine:

Depending upon residency definitions and tests pertaining to place of abode and length of time within the state, Maine domiciliaries stationed outside Maine may be exempt from the Maine income tax on their military pay.

Michigan:

Military pay not taxed.

Minnesota:

First \$3000 of military pay not taxed if service is in Minnesota; first \$5000 if outside Minnesota.

Missouri:

Depending upon residency definitions and tests pertaining to place of abode and length of time within the state, Missouri domiciliaries stationed outside Maine may be exempt from the Missouri income tax on their military pay.

New Hampshire:^{2/}

Military pay not taxed.

New Jersey^{2/}

Active duty pay not taxed.

New York:

Depending upon residence definitions and test pertaining to place of abode and length of time within the state, New York domiciliaries stationed outside New York may be exempt from the New York income tax on their military pay.

North Dakota:

First \$1000 of military pay excluded.

Oklahoma:

First \$1500 of military pay not taxed.

Oregon:

First \$3000 of military active duty pay not taxed. Moreover, depending upon residency definitions and tests pertaining to place of abode and length of time within the state, Oregon domiciliaries stationed outside Oregon may be exempt from the Oregon income tax on their military pay.

Pennsylvania:

Military pay not taxable if stationed outside Pennsylvania.

Rhode Island:

Depending upon residency definitions and tests pertaining to place of abode and length of time within the state, Rhode Island domiciliaries stationed outside Rhode Island may be exempt from the Rhode Island income tax on their military pay.

Vermont:

Military pay not taxed.

West Virginia:

First \$4000 of military pay not taxable. Moreover, depending upon residency definitions and tests pertaining to place of abode and length of time within the state, West Virginia domiciliaries stationed outside West Virginia may be exempt from the West Virginia income tax on their military pay.

Wisconsin:

First \$1000 of military pay not taxed.

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- 1/ Only states that have laws which treat military pay significantly different from the Federal income tax provisions are shown here. Also, the focus here is on active duty pay, ignoring retirement benefits, G.I. Bill benefits, etc. Combat pay exclusions more generous than those in Federal law also are not covered here (including Colorado's, which extends to income for a period of 180 days following service in a combat zone).
 - 2/ The income taxes of these states are not broad-based taxes; most persons in these states have no income tax liability to the state.

SOURCE: All States Income tax Guide, 1975 Edition for 1974 Returns (Washington: United States Air Force, Office of the Judge Advocate General, undated).

APPENDIX B

SELECTED STATISTICS ON MILITARY
AND CIVILIAN COMPOSITION

Table B-1

Military and Comparable Civilian Compensation Profiles
[1973 Pay Scales]

Years of Service	<u>1/</u> Regular Military Compensation as Percent of Civilian Compensation		<u>2/</u> Total Military Compensation as Percent of Civilian Compensation	
	Enlisted	Officer	Enlisted	Officer
1	62.5	98.6	73.1	113.2
2	67.6	93.7	79.3	108.2
3	82.6	105.6	96.9	124.0
4	84.5	118.8	105.9	140.3
5	91.4	124.1	134.4	150.2
6	91.7	122.1	121.1	149.7
7	93.5	122.3	123.1	152.0
8	92.2	118.5	122.9	149.3
9 -10	93.5	115.0	122.7	145.5
11-12	96.8	110.1	123.2	142.0
13-16	97.5	108.8	125.1	142.0
17-20	101.8	112.8	132.0	148.7
21	114.4	124.0	153.3	173.3

1/ Regular military compensation is the sum of basic pay, tax-free allowances for subsistence and quarters, plus the Federal Tax advantage on these allowances.

2/ Total military compensation includes, besides regular military compensation, the other current cash payments such as bonuses and incentive pay, as well as the estimated value of future retirement pay.

SOURCES: The Report of the President's Commission on an All-Volunteer Armed Force, (Washington: Government Printing Office, 1970), Table 5-11 pp. 53-54; and ACIR staff calculations to update this table from 1970 to 1973.

Table B-3

Indices of Military Pay, Civilian Pay, and Government Purchase Prices
1946 - 1973

Pay and purchase price indices (FY 1964 = 100)

Fiscal year	Military basic pay <u>a/</u>	Classified civilian salaries <u>a/</u>	Purchase prices <u>b/</u>
1946	48.0	50.2	
1947	59.4	57.4	
1948	59.4	57.4	
1949	59.4	63.7	78.2
1950	69.6	65.4	76.2
1951	73.0	66.3	83.3
1952	73.5	72.9	83.1
1953	75.9	72.9	82.3
1954	75.9	72.9	80.6
1955	77.8	74.7	84.6
1956	83.5	78.4	88.8
1957	83.5	78.4	94.9
1958	84.1	82.3	96.2
1959	90.4	86.3	98.1
1960	90.4	86.3	97.6
1961	90.4	92.9	99.3
1962	90.4	92.9	98.9
1963	90.4	96.5	99.4
1964	100.0	100.0	100.0
1965	105.6	106.3	102.3
1966	116.6	109.2	104.2
1967	120.3	113.3	106.8
1968	125.3	117.1	109.6
1969	135.8	124.2	113.7
1970	159.1	139.6	118.7
1971	171.9	147.9	125.3
1972 <u>c/</u>	198.5	156.4	129.9
1973 <u>c/</u>	224.8	164.5	133.5

TABLE B-2

Monthly Military Basic Pay, July 1963 and October 1974, and Monthly Non-Taxable Allowances and Total Annual Cash Pay and Allowances, October 1974, by Rank

Pay Grade	Title	Years of Service ^{1/}	MONTHLY MILITARY BASIC PAY			Monthly Non-Taxable Cash Allowances, 10/74 ^{2/}	Annual Total Pay and Cash Allowances, 10/74
			July 1963	October 1974	Percent Increase 7/63 - 10/74		
E-1	Recruit	0-2	\$ 78.00	\$ 344.10	341	\$ 116.40	\$ 5,526.00
E-2	Private	0-2	85.00	383.40	351	116.40	5,997.60
E-3	Private 1st Class	0-2	99.37	398.40	301	116.40	6,177.60
E-4	Corporal	2-3	150.00	437.40	192	133.80	6,854.40
E-5	Sergeant	4-6	205.00	513.00	150	154.80	8,013.60
E-6	Staff Sergeant	14-16	275.00	702.30	155	166.80	10,429.20
E-7	Sergeant 1st Class	18-20	340.00	825.60	143	178.80	12,052.80
E-8	Master Sergeant	20-22	370.00	948.30	156	190.20	13,662.00
E-9	Sergeant Major	22-26	440.00	1,138.80	159	202.80	16,099.20
W-1	Warrant Officer	10-12	334.00	798.30	139	220.32	12,223.44
W-2	Chief Warrant	16-18	393.00	969.60	147	234.32	14,822.64
W-3	Chief Warrant	20-22	470.00	1,150.80	145	252.72	16,842.24
W-4	Chief Warrant	26-30	575.00	1,458.00	154	269.82	20,733.84
O-1	2nd Lieutenant	0-2	222.30	634.20	185	199.92	10,009.44
O-2	1st Lieutenant	2-3	291.00	798.30	174	235.92	12,410.64
O-3	Captain	6-8	440.00	1,161.00	164	256.92	17,015.04
O-4	Major	14-16	570.00	1,470.00	158	277.92	20,975.04
O-5	Lt. Colonel	20-22	745.00	1,821.30	144	302.52	25,485.84
O-6	Colonel	26-30	985.00	2,310.60	135	322.52	31,605.84
O-7	Brigadier General	26-30	1,175.00	2,630.40	124	354.42	35,817.84
O-8	Major General	26-30	1,350.00	3,000.00 ^{3/}	122	354.42	40,253.04
O-9	Lt. General	26-30	1,500.00	3,000.00 ^{3/}	100	354.42	40,253.04
O-1	General	26-30	1,700.00	3,000.00 ^{3/}	76	354.42	40,253.04

^{1/} Longevity pay step of typical military member.

^{2/} Non-taxable quarters and subsistence allowances for officers; quarters and clothing allowances for enlisted men (E-1 thru E-9) with dependents.

^{3/} Statutory maximum.

SOURCES: The Economics of Defense Spending: A Look at the Realities (Washington: U.S. Department of Defense, Assistant Secretary of Defense [Comptroller], 1972), Table 15-1, p. 132; 1975 Uniformed Services Almanac (Washington: Lee E. Sharff, 1975), pp. 9-15 and 23-26; and ACIR staff calculations.

- a/ Military basic pay and civilian salaries are not comparable. A 4% increase in basic pay is approximately equivalent to a 3% salary increase.
- b/ Non-compensation component of the deflator for federal purchases of goods and services. Source: 1949-71, Department of Commerce, FY 1972 and FY 1973, estimated (3.7% increase for FY 1972 and 2.8% increase for FY 1973).
- c/ Reflects 1-1-72 pay raise and assumes slightly smaller pay raise 1-1-73, plus enactment of proposed volunteer-related pay legislation effective 7-1-72.

SOURCE: The Economics of Defense Spending: A Look at the Realities (Washington: U.S. Department of Defense, Assistant Secretary of Defense [Comptroller], 1972), Table 15-3, p. 134.

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COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

August 21, 1975

MEMORANDUM

TO: Members of the Advisory Commission
on Intergovernmental Relations

FROM: Wayne F. Anderson *WFA*
Executive Director

SUBJECT: ACIR Briefing of House Subcommittee on
Intergovernmental Relations and Human Resources

Because of the very substantial shared interests of the House Subcommittee on Intergovernmental Relations and Human Resources and ACIR, and the continuous need to better inform Congress about ACIR's activities, arrangements are being made for ACIR to brief the Subcommittee from 4:00 to 5:00 p.m. on Thursday, September 11. Congressman Fountain chairs this Subcommittee, which recently held a series of hearings on "Fiscal Relations in the American Federal System" to lay a basis for considering general revenue sharing re-enactment and countercyclical aid this fall.

The general purposes of the briefing, as we now see them, are to background the Subcommittee on (1) ACIR's objectives and responsibilities, (2) ACIR's views on which intergovernmental relations problems are most important today, and (3) ACIR's recent projects and recommendations and current research projects.

So that we will have the maximum number of Commission members present at the hearing, the Chairman and I urge your very best efforts to be present at that time even if you are unable to attend all parts of the Thursday Commission meeting.

The Subcommittee membership was changed substantially when this Congress organized last January. The list of current members is attached.



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

HOUSE SUBCOMMITTEE ON
INTERGOVERNMENTAL RELATIONS & HUMAN RESOURCES

Majority

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John L. Burton

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Glenn English

Don Fuqua

Barbara Jordan

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Edward Mezvinsky

Minority

Clarence J. Brown, Jr.

Robert W. Kasten

John W. Wydler

The Committee on Government Operations Chairman, Jack Brooks,
and Ranking Minority Member, Frank Horton, are ex officio
members of the subcommittee.

D



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

August 13, 1975

MEMORANDUM

TO: Members of the Advisory Commission on Intergovernmental Relations

FROM: Wayne F. Anderson, Executive Director *WFA*

SUBJECT: Report on The Intergovernmental Grant System: Policies, Processes, and Alternatives

The purposes of this memorandum are fourfold: (1) to fully acquaint Members with the nature and scope of the intergovernmental grant system project; (2) to provide some preliminary general background information that was included in the recent ACIR testimony presented before the House Intergovernmental and Human Relations Subcommittee; (3) to summarize the general findings of the first completed chapter: Chapter VII - The "Target Grant" Experience; and (4) to highlight some of the continuing issues raised by the target grant experience.

NATURE AND SCOPE OF THE INTERGOVERNMENTAL GRANTS SYSTEM PROJECT

In its 1967 examinations of intergovernmental fiscal and administrative policies (Fiscal Balance in the American Federal System), the ACIR called for a new Federal aid "mix" which would recognize the need for flexibility in the types of financial assistance provided to State and local governments. This "mix" would involve a combination of Federal categorical grants-in-aid, block grants, and per capita general support payments (general revenue sharing). Each of these mechanisms was viewed as accomplishing different objectives. The categorical grant would stimulate and support specific programs in the national interest and underwrite demonstration and experimentation projects; the block grant would give States and localities considerable flexibility in meeting needs within broad functional areas while pursuing national objectives; and revenue sharing would provide additional financial resources to State and local governments without functional restraints to conduct programs in response to their own priorities.

Now that a tripartite Federal aid system similar to that recommended by the Commission eight years ago has been established, a review of these objectives in light of the experience to date is in order. The on-going debate over the use of general revenue sharing funds by State and local governments, the continuing confusion regarding the distinctive statutory and administrative features of block grants, and the continuing growth in and concern over the future of categorical grants make this reassessment particularly timely. Moreover, the changing and crucial role of the States in the intergovernmental aid picture indicates the need for including this topic in the reassessment.

In the Spring of 1974, the Commission authorized the staff to begin work on a report concerning "The Intergovernmental Grant System: Policies, Processes, and Alternatives." The basic purpose of this study is to evaluate the traditional and recent issues involving project, formula, and block grant programs and design ways of enhancing the effectiveness of these instruments. The role of the States as prime recipients of Federal assistance, as direct providers of services to their citizens, and as dispensers of aid (from their own and from Federal sources) to their localities also will be probed. In this, the Commission's 1969 report on State Aid to Local Government will be updated. General revenue sharing will not be covered, except to recognize its nature and magnitude within the intergovernmental system, due to the recent report by the Commission on this program (General Revenue Sharing: An ACIR Re-evaluation).

Portions of the study are being funded by the U.S. Department of Health, Education, and Welfare and the National Institute on Law Enforcement and Criminal Justice of the U.S. Department of Justice.

In its initial research, staff has had to grapple with the difficulties of definitions. For theoretic as well as for practical reasons, one must come to grips with the terms used to describe the forms of financial assistance. Four factors appear critical to any attempt to arrive at a classification system which makes sense in principle and in practice.

The first relates to the extent that recipient jurisdictions are permitted unrestricted, wide, or narrow program discretion; that is, whether or not funds received must be spent on broad or specific, yet defined servicing areas. The second factor is the extent to which the aiding jurisdiction stipulates tight, broad, or nominal conditions (project or plan review and approval, administrative and reporting requirements, etc.) as the quid pro quo for receipt of assistance. A third is whether a statutorily based or dictated distributional formula or a basically discretionary allocational approach is adopted. The final factor relates to recipient eligibility and focuses on whether a broad or essentially narrow range of recipients are recognized under the pertinent legislative provision.

In diagrammatic form, the interaction of these factors would appear as follows:

Recipients'
Program Discretion

D I S T R I B U T I O N	Discretionary	Narrow	Broad	Unrestricted	Broad	E L I G I B I L I T Y
		Project Categoricals	Target Grants			
	Entitlement	Formula Based Categoricals	Block Grants	General Revenue Sharing	Narrow	
Program Conditions (Grantor Intrusiveness)						

The five-fold classifications scheme that emerges from this provides some basis for analyzing the types of intergovernmental fiscal transfers. And, while far from perfect, it also provides a starting point for efforts to gauge whether differentiating principles are reflected in practice.

As the tentative chapter outline (below) indicates, the study will be divided into four substantive parts: (1) Federal Categoricals; (2) Middle Range Reform Efforts; (3) Block Grants; and (4) The State Servicing and Aid Roles. Due to the complexity of all of these, but especially the categorical sector, sections of the study will be completed and considered out of sequence by the Commission.

The block grant experience generally, and specifically the Safe Streets program, are slated for the November Commission meeting, along with Federal Efforts to Standardize and Simplify Assistance Administration. Remaining block grant proposals and the State Servicing and Aid Roles will be considered at the following meeting in the winter. Remaining items will be dealt with in the spring with the entire report being completed by that time.

THE INTERGOVERNMENTAL GRANT SYSTEM:
POLICIES, PROCESSES, AND ALTERNATIVES

PART I

INTRODUCTION

CHAPTER I The Current Intergovernmental Grant System: In Perspective

- A. The System in Perspective: 1914-1967
 - 1. Overview of emergence and growth of Federal grants-in-aid through 1960
 - 2. Federal grants in flux: 1960-1967
 - 3. State aid to local governments: Recent Trends
- B. Developments since 1967
- C. Scope and approach of the report

PART II

FEDERAL CATEGORICALS REVISITED

CHAPTER II The Shape of the Categorical Sector

- A. The scene in 1975 in light of developments since 1967
- B. Review of rationale for categorical grants
- C. Fiscal perspective
- D. Apportionment formulas
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- F. Eligibility
- G. Functional Dimensions
- H. Programmatic and administrative conditions
- I. Summary findings

CHAPTER III Some Categorical Case Studies

CHAPTER IV Categoricals from a Current Perspective: Survey Responses, Reassessments, and Reforms

- A. Aspects of categorical grants as seen by: Congress, Federal officials, State officials, local officials, consumers, media, scholars, others
- B. Summary and conclusions

PART III

MIDDLE RANGE REFORM EFFORTS

CHAPTER V Managing the Assistance System: Assumptions, Needs, and Strategies

- A. Assistance management as a part of the broader general management challenge
- B. The demand for assistance management
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CHAPTER VI Federal Efforts to Standardize and Simplify Assistance Administration

- A. Historical Background
- B. Pre-reform conditions (1967)
- C. The Federal response
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- G. Effects of standardization, simplification, improved communication efforts as seen by Federal, State, local officials
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CHAPTER VII The "Target Grant" Experience: Appalachia, Community Action, and Model Cities

- A. Introduction
- B. The Appalachian Regional Commission
- C. Community action and the Office of Economic Opportunity
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CHAPTER VIII Federal Organization for Assistance Policy and Management

- A. Principles and Approaches
- B. Divided Responsibility: Contemporary Actors
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- A. The Traditional Fragmentation
- B. Reform and Reorganization (1967-1975)
- C. The Federal Impact: Impetus and Impediments

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BLOCK GRANTS

CHAPTER X The Definitional Dilemma

- A. The differentiating principles in theory and practice
- B. The competitors: consolidations, formula-based categoricals, and special revenue sharing
- C. Questions raised by block grants
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CHAPTER XI Partnership for Health Act: Lessons From A Pioneering Block Grant

- A. Introduction
- B. Legislative History
- C. Objectives and expectations of the consolidation
- D. Federal block grant administration
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CHAPTER XII The Safe Streets Act: Another Look at the Block Grant Experiment

- A. Introduction
- B. Legislative history
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- D. The Planning process
 - 1. State Planning Agencies
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 - 3. Part B Planning Funds
 - 4. Toward comprehensive criminal justice planning
- E. Funding
 - 1. Distribution of Part C action funds: State and pass-through
 - 2. Matching requirements and their effects
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 - 4. Effects of Congressional categorization
 - 5. "Mixing" of Safe Streets funds
 - 6. Assumption of costs by recipients
- F. City and County Officials' Perceptions on Safe Streets Program Experience
- G. Case Studies of State Administration of the Safe Streets Act
- H. Issues Raised by the Safe Streets Record
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CHAPTER XIII New Style Block Grants: Early Readings

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- B. Manpower
- C. Community development
- D. Library services and innovative programs
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CHAPTER XIV The Block Grant Record: A Comparative Analysis

- A. The block grant concept: theory and practice
- B. Congressional intent
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- E. The eligibility factor
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- A. State approaches
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- C. State matching requirements
- D. The municipal-urban dimension of State aid
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CHAPTER XVI The States and Localities as Recipients of Federal Aid

- A. Impact on State-local budgets and organization by type of Federal grant
- B. Grant participation - by type of grant
- C. Special conditions attached to Federal pass-through
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CHAPTER XVII The States as Providers of Intergovernmental Aids

- A. Characteristics of State-aid mechanisms--general government support (revenue sharing), major block or formula grants, project and small formula grants
- B. Assessment of the State-aid system

PART VI

CONCLUSIONS

CHAPTER XVIII The Categorical Grant or the Block Grant: Does It Matter Which Is Used?

CHAPTER XIX Findings and Recommendations

SOME INITIAL READINGS OF THE RECORD

In preparing testimony for recent hearings on Federal-State-Local Fiscal Relations conducted by the House Intergovernmental and Human Relations Subcommittee, chaired by Rep. L.H. Fountain, Commission staff took some initial readings of the intergovernmental assistance record. An executive summary of the ACIR statement was subsequently prepared for insertion in the Congressional Record by Rep. Fountain (See Congressional Record, July 31, 1975, page E 4292).

In order to provide Commission members with pertinent background information on this study, relevant portions of this executive summary have been excerpted as follows. Since the study is in an early stage of development, many of the findings must be considered as tentative and subject to possible future change.

THE CURRENT FEDERAL AID PATTERN

Over the past quarter century, Federal assistance to State and local governments grew dramatically in dollar amounts, number of programs, and types of functions aided. Equally significant, it was subject to major changes in program emphasis and in the forms of intergovernmental transfers used during this period.

- In fiscal year 1974, Federal financial aid to State and local governments in the form of grants and shared revenues totalled \$46 billion; recent revised estimates point to a grant outlay of over \$60 billion in 1976. This fiscal '76 figure represents no less than a 2900 percent increase for the past quarter century, since the comparable magnitude for 1949 was \$2 billion.
- Three fourths of the growth in Federal aid from 1969-1974 can be attributed to five functional classifications: natural resources, environment and energy—from 1.8 percent of the 1969 total to 4.4 percent in 1974; income security—from 23.7 percent to 24.6 percent; law enforcement and justice—from 0.1 percent to 1.4 percent; health—15.8 percent in both years and revenue sharing and general purpose fiscal assistance—from 1.9 percent to 14.6 percent.
- Over the past decade, the form of Federal assistance to States and localities was dramatically modified with the shift first moving from a categorical approach to a combination of categorical and block grants, and then to a tripartite system which included general revenue sharing. Block grants represent 10 percent of the Federal assistance; revenue sharing and general support aid, 14.3 percent; and categorical grants, though tripling in dollar amount since 1966, now account for a little over three-quarters of the estimated 1975 Federal assistance—compared to 98 percent of the 1966 total.

Categorical Aid Characteristics. Categorical grants, the chief form of Federal aid, jumped from 160 programs in 1962, to 379 in January 1967, to approximately 498 by one count and nearly 600 by another in 1974. Impressive as these numbers are, they must be handled with some caution, given the major problems associated with counting separate authorizations as against separate appropriations, and with separate programs authorized under a single authorization. Within the categorical sector, project grants numbered 100 in 1962, about 280 at the end of 1966, and well over 400 by 1974. Despite this growth in numbers, project grants in 1974 represented only about one-third of Federal categorical outlays.

What this suggests is that the bulk of the criticism leveled against the categoricals--problems of overlap, insufficient information, varying matching and administrative requirements--was levelled against the more numerous, but fiscally less significant sector. Formula-based grants obviously have expanded as well; and, while the diversity between and among these remains considerable, their numbers and associated management requirements are more manageable--at least relatively.

Block Grant Emergence. During the past nine years, five block grants have emerged. Conceptually, a block grant is supposed to embody at least four differentiating traits:

- it gives recipient jurisdictions fairly wide program discretion;

- its administrative, fiscal reporting, and program requirements are geared to keeping grantor intrusiveness to a minimum, while not ignoring broad national goals;
- its formula-based distribution provision narrows grantor administrative discretion and provides some sense of fiscal certainty for grantees; and
- its eligibility provision is fairly specific, relatively restrictive, and tends to favor general governments.

Block grants now include Partnership in Health (PHA), Law Enforcement Assistance (LEAA); Social Services (SSA); Comprehensive Employment and Training (CETA) and Housing and Community Development (HCDA). Aside from the Safe Streets Legislation, where a new program of broad functional scope was initiated, the block grants came into being by merging previously existing separate categoricals.

All five block grants meet the eligibility and formula distribution criteria. The results appear to be more mixed with regard to the program discretion and grantor obtrusiveness standards.

Federal Aid to Localities. Beginning with the low-rent public housing programs in 1937, there has been a growing tendency to make Federal grants directly to units of local government. In 1967, the Commission identified some 68 grants from which funds could be paid directly to localities. At present, there are over 90 such programs

plus an additional 46 which entail State review and comment—but not approval. While the data on number of programs are somewhat shaky, the dollar amounts are comparatively firm. Direct Federal intergovernmental expenditures to local governments rose from \$237 million in 1952 to more than three times that figure a decade later and then to \$11 billion, more than 47 times the 1952 amount, by 1973.

Equalization and Federal Assistance. Equalization of fiscal capacities can be said to take place when poorer jurisdictions receive more assistance than do their more affluent counterparts. This equalization can be achieved either by incorporating factors such as per capita income—designed as an approximate measure of recipient fiscal capacity—into the allocation formula or by matching requirements, where lesser matching is required for the poorer recipients. In some grants, it should be noted, no formula is required; nonetheless, the administering agency may in fact adopt a formula consistent with the statutorily cited factors as the best means of providing assistance to eligible jurisdictions.

At present, at least 40 Federal programs incorporate an income measure in determining the allocation of available funds.

To test the equalization tendency of Federal grants among States, simple rank-order correlations were performed relating State per capita income to: (1) total 1974 Federal aid per capita; (2) general revenue sharing per capita; and (3) total Federal aid other than general revenue sharing—a measure of both Federal categorical and block grants, 1974.

Two conclusions emerged from this analyses. First, Federal assistance as measured in the three ways discussed above does tend to equalize fiscal capabilities among States, but only very mildly. Second, there are only miniscule differences among the three aid approaches in their equalization power. The coefficients produced all tend to cluster around $-.30$; if equalization had been "perfect," this coefficient would have been -1.00 . While this equalization seems mild, it is a stronger relationship than existed in 1966, when the coefficient was $+.075$. Exclusion of Hawaii, Alaska and the District of Columbia on the basis of their being atypical States help to improve the equalization measure in both years for total Federal aid, the combined categorical-block measure, but not for general revenue sharing. On the other hand, general revenue sharing has a somewhat stronger tendency to equalize tax effort (the ratio of State-local tax revenue to State personal income) than does either of the other two measures of Federal aid.

Equalization is but one of several objectives for disbursing Federal assistance. Because categorical grants attempt also to stimulate the provision of services, promote demonstration or innovative projects, compensate for the underprovision of services that would result because benefits spillover into jurisdictions other than the one financing the particular service, some have concluded that the unconditional grant is the preferred instrument when equalization is the objective. Moreover, equalization seems a more appropriate concern in people related programs—rather than

capital development projects--particularly where a nationwide level of services is sought. Even where equalization is desired, however, political realities suggest that this concern must be combined with other objectives to secure legislative adoption.

The Nature and Magnitude of the Flow of
State Aid to Local Government

State aid totalled \$40.8 billion in 1973, the latest year for which data is presently available, and is currently approximately at the \$50 billion mark. Although about 20-25 percent of State aid represents money that originates at the Federal level and is passed-on by the State to its local governments, the great majority of such financial assistance is raised by the State sector. Such assistance is provided for general local government support, education, welfare, highways, public health, public hospitals, and a miscellaneous and combined purposes category that is largely a collection of municipal-urban programs. Public education is--and always was--by far the largest single component of the State aid package, accounting for more than 57 percent of the 1973 total.

In terms of types of grants, formula based--not project grants--are the overwhelmingly preferred transfer mechanism, accounting for nearly \$36.0 billion of the \$36.8 billion in State aid for 1972 and representing 1809 of the 2120 State grants for that year, the last for which individual program data is available.

GROWTH. Perhaps the most obvious, though nonetheless significant fact to be noted about State aid is its virtually uninterrupted growth during the twentieth century. The most dramatic expansion in State aid has taken place during the past twenty-five years. Not until 1952 did State aid reach the \$50 billion level; ten years later, it had more than doubled. In the most recent ten year period, however, State aid more than tripled—rising from \$10.9 billion in 1962 to the 1972 mark of \$36.8 billion. Even when adjusted for price changes and population growth or when expressed as a ratio of total local revenue, the story of State aid is a story of growth throughout the twentieth century.

Composition. The sole significant and sustained trend in the composition of State aid has been the relative decline in State support for public highways. The 7.2 percent figure registered in 1972 for this functional area was the third lowest for the entire century, reflecting the expanded scope of other State aided activities over the years.

Recipient Governments. The largest single slice of State aid is channeled to school districts for the support of public education. Over the period 1957-1972, the share of State aid received by school districts held virtually steady at or near the 50 percent mark. Counties and cities are the second and third largest State aid recipient governmental units, receiving 26.3 and 23.4 percent, respectively. Although neither jurisdictional type recorded an uninterrupted trend in the share of State aid received, there has been a perceptible narrowing of the differential, in favor of the municipalities. Counties, however, have continuously received the largest share—though the margin of difference which stood at 7.4 percentage points in 1957 was narrowed to 2.9 percentage points in 1972.

Recent Innovative Forms of State Aid. Although the vast majority of State aid continues to be channeled for the support of the "big four"-- education, highways, welfare, general local support--the provision of financial assistance for programs and functions of an urban-municipal character has grown rapidly in the past five years, though still accounting for a small part, roughly 3 percent of the 1972 State aid total.

To illustrate, 12 States had a total of 18 programs in the fields of public housing and urban renewal in 1972, with State aid totalling \$100.9 million; by way of contrast, only seven States provided a total of about \$67 million in 1967. State support for water and sewer programs rose even more dramatically--from 10 programs and \$26.3 million in 1967 to 33 programs and \$37.4 million five years later. Mass transit, supported by only three States in 1967 and commanding a mere \$48 million, rose to a total of seven States, supporting eight individual programs, amounting to \$116 million in 1972.

In total, there were some 220 programs of State assistance for urban-municipal functions, totalling \$948 million in 1972. The most widespread of these programs were library aid (42 programs), water and sewer facilities (33), airports (32), and police and/or firemen's pensions (23). For the remaining program areas, the State response is sporadic, rather than widespread.

The Relationship of State Aid to Direct Provision of Services. States also aid local governments by assuming direct responsibility for the provision of public services. The State of Hawaii stands out as an extreme example of direct provision of services. It assumes, for example, complete administrative and financial responsibility for public welfare and elementary and secondary education.

For all States, intergovernmental expenditures, expressed as a percent of total State general expenditures, has increased modestly in the recent past—from 34.9 percent in 1962 to 35.7 percent in 1967 and to 37.2 percent in 1972. Among individual States in 1972, the proportion extended from a low of 2.6 percent in Hawaii to a high of 57.5 percent in New York.

There is some evidence that these States directly providing services tend to do so at the expense of providing intergovernmental aid. This "trade-off" shows up, although only mildly, in the highway and public welfare categories; it did not emerge, however, in the education function or the total of State aid.

The Scope of State Revenue Sharing With Local Government. State government revenue sharing programs in 1972 accounted for \$4.3 billion or 10.2 percent of State aid. In dollar terms, this is roughly the same as the \$4.1 billion Federal revenue sharing to local governments provided in fiscal 1975.



The State programs are split nearly 50-50 between those incorporating equalization features and those that do not. Just under \$1.0 billion of this type of State assistance is returned to localities specifically on an origin basis; an additional \$764 million is sent back in the form of in-lieu payments. Of the \$1.7 billion this is considered equalizing, more than \$1.2 billion is allocated on the basis of population—a tax equalization factor that may accomplish the redistribution objective of Federal revenue sharing where the dominant tax instrument is a progressive personal income tax, but is less likely to do so in State aid systems.

State Aid and the Equalization of Local Fiscal Resources. The equalization objective in State-local fiscal relations is virtually confined to the education function and is nearly absent in other public programs. Of the total \$36.8 billion in State aid, \$15.1 billion or 42 percent was apportioned by measures that suggest an equalizing intent. This \$15.1 billion breaks down as follows:

- \$13.1 billion, public education;
- \$1.7 billion, State revenue sharing programs;
- \$568 million, public highways;
- \$24 million, miscellaneous and combined—largely the urban-municipal aid;
- \$21 million, public welfare; and
- \$7 million, public health.

Central City-Suburb Comparisons. This general absence of equalization in the State-local transfer system also emerged from a 1970 analysis of the 72 largest metropolitan areas. Within these metro areas, State and State-administered Federal aid averaged \$123 per capita in the central cities vs. \$121 in the suburbs. Only those central cities in the Northeast fared better than their suburban counterparts (\$148 vs. \$128 per capita). Direct Federal-local aid, however, while smaller in magnitude was a mitigating factor--favoring all but seven central cities in the 72 metro areas throughout the country, and averaging \$28 per capita in the central city vs. \$9 in the outside areas for the nation as a whole.

In terms of a functional breakdown, central cities were generally at a disadvantage in education aid (\$65 per capita vs. \$83 per capita), but favored in the noneducational assistance (\$86 per capita compared to \$47 per capita).

FINDINGS OF CHAPTER VII: TARGET GRANT EXPERIENCE

Summary findings stemming from this chapter are included herein for information purposes.

The Target Grant Experience.

Introduction. Among the important initiatives of domestic policy undertaken in the years 1964-66 was the creation of three particularly innovative programs of Federal assistance to States and local communities. These included programs authorized under the Economic Opportunity Act of 1964 (community action); the Appalachian Regional Development Act of 1965 (ARDA); and the Demonstration Cities and Metropolitan Development Act of 1966 (model cities). Although the classification of grants by type is difficult, all of these programs often have been identified as "target grants." Chapter VII reviews the findings of various evaluations of these programs, and attempts to draw lessons from the target grant experience.

Distinctive Traits. It was a basic premise of these programs that certain areas and population groups were receiving insufficient assistance under existing Federal categorical aid programs. The normal operation of these programs, it was felt, had not "targeted" resources sufficiently on areas of greatest need or development potential, nor permitted a comprehensive strategy for the resolution of the problems of these areas. The new programs were intended to redirect and supplement this existing aid.

Among the important distinguishing characteristics of a "target grant" are the following:

- an emphasis on the provision of services to a particular target area or population;
- an attempt to "coordinate" or focus assistance from a broad range of existing categorical programs on the target area, in addition to supplementary assistance;
- a reliance on recipient-prepared comprehensive plans to attain coordination objectives, with support from new Federal interagency organizations or procedures;
- great flexibility for recipients in determining the nature of projects to be given Federal support; and
- comparatively strict Federal conditions or procedures governing the receipt of funds.

In their broad functional scope, the target grants bear considerable similarity to block grants and even revenue sharing. Yet, their other traits--especially the "targeting" and stringent Federal conditions--resemble more the characteristics of some categoricals. Moreover, unlike nearly any other form of Federal aid, these programs required a high degree of coordination among Federal departments, and an equally high degree of interagency coordination as well as overall managerial capacity within recipients jurisdictions for full success.

Findings. In Chapter VII, the three target grants were examined almost exclusively in terms of this coordination effort. Experience with the programs point to several general conclusions:

- None of the programs experienced more than limited success in coordinating or integrating the use of categorical assistance; Federal disunity was a major obstacle to the achievement of this objective.
- The theoretical conception of "coordination" upon which the programs were based appears to have been inadequate; coordination was equated with cooperation; the record suggests that effective coordination is, in fact, a power rather than a cooperative relationship.
- In no case was improved coordination the overriding objective of a program; in practice, such other purposes as the delivery of services often came to receive priority; this usually reduced the ability to attain coordinative aims.
- Numerous obstacles faced recipients in the development of technically adequate comprehensive plans; many commentators believe that planning theory and practice were not adequate to the complex tasks undertaken by the programs.
- Marked differences in performance were found from area to area; some recipients more nearly achieved program objectives than others; political considerations, especially the degree of leadership provided by elected chief executives, were key factors.
- Too much was expected too soon, given the complexity of the difficulty of achieving basic social changes; moreover, the Federal government moved too quickly from one coordinative strategy to another, engendering some additional interprogram conflict.
- The "targeted" nature of the programs was reduced to some degree by pressures to serve expanded areas or additional recipients.

Overall, a reading of the record of these programs is pessimistic in terms of the coordination and targeting of Federal categorical assistance. Each program, of course, made contributions in other important respects.

ISSUES RAISED BY THIS EXPERIENCE

The target grant programs were the first major attempt to coordinate and manage the Federal assistance system on a comprehensive basis. Initiated in 1964-66, they preceded the host of other reforms in Federal aid which have found a place in today's intergovernmental relations. They were the forerunners of these later efforts, and in some cases the direct antecedents from which they grew.

Their importance, then, is in part simply historical. Model Cities, of course, was "folded" into the new community development block grant, and the Office of Economic Opportunity has been succeeded by the new Community Services Administration with community action now having a much diminished role in national social policy. The Appalachian Regional program clearly is alive and well and would appear to be strengthened by amendments adopted by the Senate this year to the pending renewal legislation. Overall, however, the bulk of the target grant record relates to programs of the past.

Yet, the relevance of this record to contemporary intergovernmental relations should not be overlooked. The target grant experience, after all, suggests lessons for those who are seeking to improve the current system. To the extent to which the programs succeeded, they offer models which may be adopted in other contexts. In their weaknesses, they frequently reveal problems which still face us and still require corrective action. These target grants also raise value-laden issues involving

the varying goals or purposes to which Federal assistance may be directed. In short, the record and the issues raised by it merit the attention of those seeking a better understanding of the Federal grant system.

What is a Target Grant? The targeting concept, itself, is a basic question raised by the experience under these grants. It is not, after all, a simple approach, but one involving several distinct components. Each of these is a basic feature of the targeting approach, and at least five such components may be identified:

1. Fiscal concentration--the restriction of expenditures to a limited number of specified areas.
2. Functional flexibility--the ability of recipients to undertake a wide variety of activities, with few constraints.
3. Multi-agency support--including the ability to draw upon a considerable range of existing Federal assistance programs.
4. Broadly integrated mobilization of recipients--cooperative participation by the full set of relevant public and private agencies and jurisdictions at the recipient level.
5. Comprehensive analysis and planning--recipient determination of priority problems, objectives, and strategies.

In setting forth these criteria, we recognize the danger of confusing theory with facts. The same danger is involved in definitional discussions of other forms of assistance programs. Most programs contain some distinctive features; there are no "pure types." Only with difficulty can "model" block grants, formula grants, or project grants be developed. Even general revenue sharing might take a wide variety of

forms. Any classification, then, is somewhat artificial; yet, it is vital for analytical purposes since it provides a point of departure to gauge the extent to which differentiating principles are reflected in practice.

Fiscal Concentration. The target grant concept requires that expenditures be restricted to a limited number of areas. These, in turn, are identified by some measure of need. Such concentration permits a relatively high level of Federal expenditure in the few localities selected. Thus, services may reach the threshold level or "critical mass" required for effectiveness. In contrast, other grant mechanisms--especially the formula grants--sometimes are criticized for their scattering effect. Limited resources are spread far too widely, and stretched too thin. This is especially so when formulas are used to determine substate allocations that lack severely restrictive eligibility provisions. Target grants usually are awarded like project grants--administratively, and on a case-by-case basis.

The legislative provisions of each of the three target grants held some correspondence to this model. The legislation itself provided allocational guidelines--some strict, others limited. Yet, the final determination of recipients was left to the Federal administering agency and its discretionary processes, or in the case of Appalachia, to the Regional Commission.

The ARDA delineated the boundaries of the multistate region to be served. More importantly, the Act required that projects approved be concentrated in areas having a significant potential for economic

growth. In making awards, the Commission also was to consider the wealth and unemployment rates of an area. In other respects, it was given wide discretion in allocating funds.

The Demonstration Cities and Metropolitan Development Act indicated that there was to be "equal regard" for the problems of small and large cities. Financial assistance for the execution of demonstration programs was subject to the limitation that no State would receive more than 15 percent of the aggregate authorization. The number of participants was not otherwise specified or limited. Participants in the model cities program also were required to delineate "model neighborhoods" in which resources would be concentrated.

The 1964 Economic Opportunity Act provided some Congressional guidance on the allocation of funds. Section 203 of the Act provided a formula for the allotment of funds among the States on the basis of public assistance recipients, unemployment, and children in poverty. The incidence of poverty within a community was to be considered before extending assistance, and funds were to be distributed equitably between rural and urban areas. CAAs were encouraged, but not required, to identify target areas possessing high concentrations of poverty.

In practice, the target grant programs failed to meet high standards of fiscal concentration. The number of program participants was fairly large in each case. As a consequence, available funds were stretched thin in at least two of the three programs.

This affected many aspects of the operation of each program. Examples may be cited. Model cities, once conceived as a "demonstration" program for a handful of cities, went through two full rounds of awards, bringing the total number of participants to 150. Essentially all large cities were included. The OEO attempted to mount a program in every county in the nation, rather than concentrate expenditures in the most severely disadvantaged areas within each State. The Appalachian Regional Commission has permitted each State to identify its own growth areas by its own methods, rather than utilizing regionwide criteria based upon uniform analytical procedures. Only moderate levels of expenditure concentration have been attained, with considerable variation from State to State. After promptings by the Congress, the Commission recently devised a new subregional strategy which provides increased aid to the lagging areas of central Appalachia. Yet, to some degree, this approach conflicts with that of favoring areas with the greatest growth potential.

The record suggests that it may be impossible politically to obtain a very high degree of expenditure concentration through the target grant approach. The Congress, in the first instance, is unlikely to approve legislation which benefits the constituencies of only a small proportion of its membership. Broad participation normally will be required in the program itself, or through another program on a quid pro quo basis. Administrators, in turn, are mindful of the necessity to return to the Congress for appropriations or new authorizations, hence the need to build a working coalition of supporters. This fact of administrative life cannot be ignored in awarding grants. Bodies of coequals, like the ARC, tend to

allocate funds among their members in a manner which seems "fair" to those involved.

These political considerations are, of course, not peculiar to the target grants. They arise in every other context. With revenue sharing, block grants, and formula categoricals, they can affect the legislative development of the allocation formula. They may also appear in administrative decisions concerning the awarding of project categoricals. Comparable political pressures exist at the other levels of government.

Having made the point, it must be said that some degree of expenditure concentration was achieved by these target grants. Whether it was sufficient remains a matter of judgment.

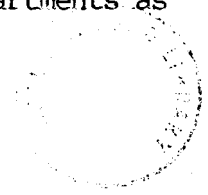
Functional Flexibility. The "model" target grant provides considerable flexibility for recipients in determining the specific uses to which funds may be put. Such breadth is necessary, because the programs are intended to meet the multiple needs of the target group or area. Flexibility also can encourage local initiative in the development of innovative projects.

The initial legislation for each of the three programs, in fact, permitted considerable flexibility. The programs were multi-functional in nature, and were considerably broader than the current essentially uni-functional block grants. In this one respect, they may more appropriately be compared to general revenue sharing. Neither the Economic Opportunity Act nor the model cities legislation specified the exact nature of the services to be provided, but simply required that these be aimed at the general objectives of eliminating poverty and improving the quality of urban life. The restrictions imposed were, instead, chiefly organization and procedural.

The Appalachian program was somewhat more limiting. The 1965 ARDA created nine programs of categorical assistance as well as a program of supplemental grants. Initially, separate appropriations were made for each program. These programs did embrace a considerable variety of activities relating to economic development, among them highways, vocational education, health facilities, and low-cost housing. Supplemental funds could be applied to an even wider variety of public facilities projects.

In the case of model cities and the Appalachian program, the flexibility intended by the authors of the legislation was largely realized. A variety of activities were or are assisted. Indeed, the Appalachian program has increased in flexibility over time. Under the ARC's new "single state allocation" procedures, the States receive what is in effect a single "block grant" which may be used for most non-highway purposes. The "first dollar" authority now embodied in the supplemental assistance programs permits the States to use these funds in place of other Federal categorical aid monies when they are insufficient to meet pressing regional needs.

Community action provides a pointed contrast, for the program quickly lost much of the flexibility which was a part of the original concept. Both the OEO and the Congress adopted the practice of "earmarking" funds for specific national emphasis programs, such as Head Start. These programs grew at the expense of those initiated at the community level. They acquired their own administrative apparatus within the OEO and developed distinct clienteles. In effect, community action was "categorized," and a number of the programs later were "spun off" to other departments as new categorical grants.



This development reflected dissatisfaction with the type and quality of some of the projects initiated at the lower level. Some of these had proven controversial, and tended to cast a shadow over the entire community action concept. The OEO itself stressed the national emphasis programs, believing them to be more effective and more popular. They provided a means of demonstrating comparatively rapid progress, which was felt to be a political necessity if the program was to survive.

All the differences between the developmental history of the OEO, on the one hand, and Appalachia and model cities, on the other, are not easily explained. A clear factor, however, was the greater controversy surrounding the OEO's community action program. Some would attribute this to the fact that most CAA's were private, nonprofit bodies, rather than units of general-purpose government. The greater stress on citizen participation in community action may have provided an inadequate balance between neighborhood and other interests, especially those of elected community leaders.

Multi-agency Support. The targeting approach seeks the coordinated use of a broad range of Federal assistance programs. The system of categorical aids was to be redirected to focus on specific target areas in support of broad national antipoverty or developmental objectives. Responsibility for the success of the programs was to some degree shared, since it cut across departmental lines.

This feature provides a crucial point of contrast with the more recent block grants. The latter typically have been created through the consolidation of earlier categorical programs, and are administered by one department. They are, then, replacements for certain categorical aids. In contrast, the target grants sought to focus this aid and to supplement it, not to supplant it.

Such multi-agency support was desired for the same reasons that functional flexibility was sought. It would permit recipients to mount a wide-ranging, truly comprehensive program. There also were considerations of economy. Smaller additional appropriations would be required if existing grants provided some of the financial base for the programs.

These features were most clearly embodied in the Demonstration Cities Act. Model cities activities were expected to be based chiefly upon existing categorical grants. The program guide listed more than forty such grants, administered by more than ten Federal agencies, which might be incorporated in a local demonstration plan. The Demonstration Cities Act itself provided new grants as supplements to this other aid, and for planning. The 1964 Economic Opportunity Act required that other Federal agencies give preference to applications for aid made as a part of a community action program. The OEO Director was authorized to gather and distribute information relating to such programs in order to insure that they would be utilized to the maximum extent possible. Moreover, a multi-agency Economic Opportunity Council was created as an interdepartmental coordinating mechanism.

The Appalachian approach was somewhat different. Less stress was placed upon the use of other assistance programs. However, the ARC was to serve as a focal point for all Appalachian development activities. The Federal Development Committee for Appalachia had interdepartmental membership, and was to promote coordinated planning. The plans prepared by the States were intended to provide a useful overall developmental strategy. Section 214 supplemental grants were intended to make full participation possible in other categorical programs for which necessary matching funds otherwise would have been lacking.

In practice, none of the programs received broad Federal multi-agency support. Each was operated at the national level in a more or less isolated fashion, and interagency conflict--not cooperation--characterized a number of the horizontal relationships. Local model cities demonstration agencies made far more limited use of categorical funds than had been anticipated. Instead most activities were financed by the supplemental grants. HUD, working through interagency committees and with White House backing, did seek to have other Departments "earmark" or reserve funds for use by local CDAs. However, only one Department, HEW, made a significant response. The Economic Opportunity Act's preference provisions were never implemented adequately, and were, in fact, dropped during the 1967 amendment process. Local CAAs had minimal impact on the flow of other Federal funds. The Appalachian Regional Commission has had little success in influencing the programs of other Federal Departments. These have followed their own, often conflicting, investment or assistance strategies.

These events suggest the practical difficulties of securing joint action among several Federal Departments. They highlight the perennial force of the "functional fiefdoms" in the intergovernmental system. Every agency is constrained in its actions by its own organization needs, bureaucratic traditions and procedures, internal administrative strengths and weaknesses, as well as separate legislative authorizations and mandates.

Interagency committees of the kind associated with each of these programs appear unable to overcome these centrifugal forces. Even the prestige of a position within the Executive Office of the President proved insufficient in the case of the OEO's Economic Opportunity Council. The rule that "equals can not coordinate equals" seems supported by these cases.

More might have been achieved if the programs had received strong, continuous White House backing. President Johnson's commitment to community action declined, and model cities lacked strong Presidential support during the Nixon administration. However, any program which requires continuing intervention from the highest levels for its success is apt to have difficulty. The many demands on a President means that his continuing involvement cannot be assumed.

Broadly Integrated Mobilization of Recipients. The targeting concept requires a broad, integrated response at the recipient level as well as at the national level. In the case studies analyzed, a comprehensive approach to antipoverty or developmental activities could not be mounted without a high degree of joint action by State or local departments and jurisdictions. This high degree of interagency coordination is not easily attained. Municipal departments frequently operate with high degrees of autonomy. Many public services are provided by separate governmental units, including the county, State, and special districts.

Community action stressed the need to link the separate services systems in education, health, welfare, housing, and other areas. All available local resources were to be mobilized and focused. The membership of the governing body of the CAA was to be broadly based, with representatives of the general-purpose government, board of education, public welfare agency, and other organizations--public and private--as well as residents of the area served. Model cities demonstration agencies were to obtain full cooperation from independent public and private agencies, and to assure that their efforts were mutually supportive. Each State's Appalachian plans

provided a mechanism for coordinating the activities of various State departments. At the local level, a system of local development districts, often organized as a council of governments, were to promote coordinated planning.

The record of achievement on this point is mixed. Local community action agencies seldom were able to develop widespread involvement by other local agencies. Most operated in isolation, focusing on services which they funded themselves; conflict with other agencies was more common than cooperation. Appalachian plans generally have had little influence on the activities of other State departments. While a system of LDDs has been created throughout Appalachia, most bodies of this kind have limited coordinative powers.

Model cities, on the other hand, has been judged to have been far more successful in this respect. Its planning process brought together officials who had previously had little contact, and linked them in common efforts. Efforts to secure private agency involvement, however, secured little success. Under model cities and planned variations, the overall coordinative role of the chief executive was often strengthened.

These contrasting findings suggest the importance of strong recipient political leadership and support in producing systemic responses. Model cities apparently achieved a greater coordinative impact than community action because it was more clearly linked to the leadership of general-purpose governments. Analysis indicates that the commitment of an elected chief executive was a vital factor in those cases where the program's objectives were most nearly attained. To some degree, a skilled and committed leader apparently is able to overcome the structural fragmentation which characterizes many local governments.

Comprehensive Analysis and Planning. Comprehensive planning lies at the core of the target grant concept. Analysis provides a means for identifying problems and ranking them by importance. Symptoms are distinguished from underlying causes. The planning effort includes the setting of goals and the development of strategies to reach them. Funds can then be "targeted" into the specific kinds of activities where they will have the greatest impact.

The model cities program required the preparation of highly-detailed comprehensive plans. A one-year planning period was included as a part of the program. The Appalachian Regional Development Act provides that the ARC shall develop comprehensive and coordinated plans and establish priorities for investment. Far weaker, however, were the planning provisions in the 1964 Economic Opportunity Act. While a one-year planning period had been a feature of the draft legislation, this requirement ultimately was dropped. The OEO's "building block" approach permitted some activities to be initiated before a plan for comprehensive services was prepared.

The experience with these programs highlights some of the obstacles to comprehensive planning and analysis. Most CAAs never prepared comprehensive plans, but simply attempted to meet the OEO's limited requirements. Both the Congress and the OEO had felt that a lengthy planning period would delay the progress of the program. Hence, neither required that more extensive planning be done. The increasing importance of the national emphasis programs took much of the meaning out of the local planning concept, since funds were not available for the execution of locally-initiated programs. Stronger planning requirements were included in the 1967 amendments, but they apparently had little impact.

Few CDAs were able to comply with model cities' far more demanding requirements or meet the prescribed timetable. Too often, as in community action, a series of possible, often unrelated projects were simply strung together. The necessary analytic capability simply did not exist in most cities.

The Appalachian Regional Commission has never prepared a region-wide multistate plan. The plans prepared by the States themselves have been of varying quality. Initially, many were prepared by consultants or showed other procedural weaknesses. Moreover, many LDDs have focused on "grantsmanship" activities, rather than planning.

Over the years, however, the planning capabilities of many of the Appalachian States as well as several model cities have improved. High-quality comprehensive planning clearly takes a considerable amount of time. Those who are impatient for results tend to find this objectionable. Many localities appeared to lack the technical expertise for the development of such plans; and, at least in the late sixties, trained manpower was in short supply. Many commentators also believe that the planning theory underpinning the concept was inadequate or unrealistic. Traditionally, planners had been concerned chiefly with questions of physical design and land use; few had engaged in the analysis of complex social problems. Moreover, planning theory had assumed both a unified and a highly centralized administrative system. Both are lacking in large urban areas and in multi-state regions.

The above analysis suggests that the target grants fell short of achieving certain of their goals. Some of the reasons for these mixed results relate directly to the specifics of these individual programs, especially the complexity of the device itself and the intractability of the social and economic problems with which they were supposed to deal. Yet, other reasons for these outcomes relate to more general conditions and attitudes. These, in turn, raise questions that clearly have relevance to current efforts at improving our system of intergovernmental assistance.

- Is it possible, either in the short or the long run, to target assistance according to objective criteria of need without adopting the "scatter widely" approach?
- If widespread participation is necessary, does not targeting, whether by statutory formula with need factors weighted or by administration action pursuant to statutory guidelines, require far greater fiscal resources than the initiators of such programs or economic analyses usually call for?
- Can any broad multipurpose intergovernmental assistance program remain free of the intrusions of the granting government, if it involves significant amounts of aid dollars and if it encompasses, either in whole or in part, activities that are of continuing interest to it?

- Can any attempts at packaging significant amounts of funds from diverse departments and agencies succeed without steady and strong intervention from the chief executive of the grantor government?
- Can any assistance program succeed in achieving the full mobilization of recipient governments, if the broad goals sought are not fully shared by their political leadership?
- And, closely related to the above, to what extent is it feasible or even desirable for a grantor government to seek integrated responses by recipient units, given their structural, administrative, and political diversity?
- Can comprehensive planning ever be comprehensive, if it is dominated by functionalists? Can it even be useful, if it is not dominated by generalists? Can it ever be sensible, if it has to be produced as a fixed product in a year or a year and a half? Can it ever succeed, if it must compete perennially with current political cries for immediate results?

These questions underscore the need--when approaching intergovernmental policy matters--for political realism, a sensitivity to bureaucratic operations, an appreciation of the nation's continuing socio-economic and governmental diversity, an awareness that complex problems usually generate complex solutions, and a recognition that quick solutions to such problems merely complicate the job of the next generation of policy-makers.

E



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

August 21, 1975

TO: Members of the Advisory Commission on
Intergovernmental Relations

FROM: Wayne F. Anderson *WFA*
Executive Director

SUBJECT: Proposed USDA Forest Service-financed Study of
the National Forest Shared Revenue Program

The National Forest Service has requested ACIR to examine the fairness of its present system for sharing receipts with counties. Currently, Federal legislation provides that 25 percent of the receipts from revenue producing activity--especially timber cutting and leasing of recreation sites--on national forest lands be shared with counties and spent on schools and roads. In fiscal year 1974, the Forest Service paid about \$114 million to 700 counties in 39 States. Other Federal shared revenue programs covering mineral leases and grazing rights on Federal lands provide much smaller amounts.

County governments have criticized the shared revenue system for national forest lands on two main grounds:

1. Some counties receive virtually no help from this source because some national forests have little marketable timber;
2. Some local budgets rise and fall drastically from year to year because of the wide fluctuations in annual receipts from timber cutting.

County officials suggest that these problems could be cured by enactment of Federal legislation to give counties the option of choosing Federal payments under (a) the present shared revenue program or (b) an in lieu of local property tax program.

Intergovernmental tensions brought about by the present shared revenue program are likely to intensify. The value of Federal lands shows every prospect of increasing. More and more money is at issue because timber prices have reflected the general inflation and certain raw material shortages in recent years. Recreation sites are constantly being sought for a growing and more affluent population. More intensive use of Federal forest and other lands may generate additional demands on local governments in close proximity, and intensify the efforts of local government officials to obtain a larger and more certain payment from the Federal government.

Forest Service contribution to the study.

The ACIR staff is presently committed to the limit of existing resources on projects previously selected for study by the Commission. Additional staff would have to be recruited to undertake the proposed research. The Forest Service has offered to provide financial support for the Commission to hire staff and carry out this study in accordance with usual ACIR procedures. The Forest Service would also assist the Commission in obtaining and analyzing the data it has as a result of its administration of the shared revenue program. The study, we have estimated, can be completed by a team of two professionals in 15 to 18 months.

Evaluation of Proposed Research Project

Staff conclusions on the potential benefits of the proposed forest lands project and description of a problem concerning the project's scope follow.

Potential benefits of this study.

While the study of the national forest shared revenue program would be of specific help to the Congress and the Forest Service, we believe it would also be a valuable experience for the Commission. The project could develop principles and methodologies that might be applicable in other areas where Federal tax immunity contributes to intergovernmental tension. For example, the energy crisis has heightened interest in oil, oil shale, and coal on or under Federal lands and waters. Although such lands and waters may differ in major respects from timberlands, some of the analyses of intergovernmental equities, costs, and

benefits associated with timberlands may be analogous. Similarly, the analysis of Forest Service shared revenues may disclose concepts and methods that can be usefully applied when consideration is given to the intergovernmental impact of developing mineral lands, the resources on the Outer Continental shelf, and other categories of Federal lands.

The ACIR staff, particularly when engaged in property tax studies, has been well aware of, and very interested in, intergovernmental problems related to Federal and State properties that are exempt from local property and other taxes. Such tax exempt property is a well known point of intergovernmental friction, typically minor in localities where there is only a modest amount of such Federal and State property but a serious aggravation of local finances where there are substantial Federal or State installations or land holdings.

While substantial research efforts were undertaken by other organizations during the fifties and late sixties, there are many segments of the tax exempt property subject that are largely unresearched. The subject is vast because of the numerous distinctive categories of Federal and State property, and practice on compensating local governments takes many forms and ranges all the way from no compensation to the equivalent of full property taxation.

ACIR has not undertaken research in this exact field, but the staff believes that the subject ranks in the upper middle on the intergovernmental problems list, that research on parts of the problem would be an appreciated intergovernmental service, that prospects of altering current practices are fair to good, and that ACIR is well qualified to deal with this subject matter. As was stated earlier, we further believe that a study of one or several categories would very likely lay a basis for further studies and ultimately for development of general principles and methodologies which could be applied generally with reference to many categories of Federal and State property serviced to some degree by local governments.

Problem concerning scope.

Subsequent to our first meeting with the National Forest Service representatives, we have also conferred with

the staff of the House Subcommittee on Intergovernmental Relations and Human Resources, which has jurisdiction over the pending legislation on forest lands and certain other categories of Federal property, and the National Association of Counties. All three parties warmly support ACIR's conducting research relating to the forest lands. However, their positions on whether other categories of Federal property should be included in the study diverge, but there is an approach that accommodates the three positions acceptably.

The National Forest Service's interest is understandably limited to the Forest Lands for which it is responsible, but they would not object to other categories being included providing this expansion did not adversely affect progress in studying the forest lands and provided that financing of the study was on an equitable basis. The staff of the House Subcommittee prefers that the study encompass mineral and grazing lands as well as forest lands and perhaps even the Outer Continental shelf. NACO wants mineral lands included, is favorably disposed on including grazing lands, and has no interest in offshore oil.

On the basis of very limited probing, the ACIR staff believes that forest, mineral and grazing lands might be logically studied together, that certain payment in lieu approaches may be common to the three categories, and that modest efficiency gains would be achieved in studying them together. We, however, have the National Forest Service request and financing in hand but no obvious source of additional financing for the larger study. Admittedly, as of this date, we have not yet undertaken discussions with the Department of Interior, which has jurisdiction over the mineral and grazing lands, and have not intensively searched for additional financing. However, discussions to date do cause us to believe that considerable problems and delay could be encountered in trying to put together the larger study encompassing the three categories of land.

Recommendation.

The various parties at interest referred to above would be reasonably well satisfied if ACIR moved ahead with the Forest Land study but continued its efforts to launch a study of mineral and grazing lands either as a later add-on to the forest land study or as a separate second phase. I therefore request and recommend that the Commission authorize

an ACIR study of the USDA-National Forest Service shared revenue program for national forest lands, subject to completing satisfactory arrangements for the necessary grant from the National Forest Service, and that the Commission also authorize study of Federal mineral and grazing lands to be undertaken if and when financing of the study from an appropriate outside source can be secured and Department of Interior participation in the study arranged.

F



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

August 21, 1975

MEMORANDUM

TO: Members of the Advisory Commission
on Intergovernmental Relations

FROM: Wayne F. Anderson *WFA*
Executive Director

SUBJECT: Request that ACIR Undertake Research and
Development Transfer Project

As the attached letter states, the Big 7 Public Interest Groups have requested that ACIR undertake an assessment of ways to improve the sharing of Federal research and development with State and local governments.

We are currently in the process of conferring on this matter with the designated public interest group representative, the National Science Foundation, and other knowledgeable parties. We are endeavoring to evaluate the existing research in this field, what additional research or other steps are appropriate, whether ACIR has or could secure the required research competence, and whether funding is available.

This matter has been placed on the agenda because of the likelihood that deliberations will have advanced sufficiently so that I will be able to report orally and seek a Commission decision at your September 11-12 meeting.

Council of State Governments
International City Management Association
National Association of Counties
National Conference of State Legislatures
National League of Cities
United States Conference of Mayors

May 9, 1975

Mr. Robert Merriam, Chairman
Advisory Commission on Intergovernmental Relations
726 Jackson Place, N. W.
Washington, D. C. 20575

Dear Mr. Merriam:

On behalf of the major public interest groups representing state and local governments in the United States, this is to request that the Advisory Commission on Intergovernmental Relations undertake an assessment of ways to improve the sharing of Federal research and development with state and local governments.

As you are aware, the Federal government is the principal sponsor of research and development (R&D) in our governmental system. Compared to Federal R&D spending of over \$20 billion in 1974, for example, state and local governments combined spent little more than \$200 million. Since about one half of Federal R&D spending is for domestic problem-solving for which there is operational state and local government responsibility, it is obvious that there must be the closest of working relationships between the levels of government if Federal R&D programs are to have their intended beneficial results.

Despite several previous assessment efforts which document needed programs and a Presidential message on this subject, there has been very little follow-through by Federal agencies. We believe that this may be because of the initiative for previously generated documents came from the research community and such documents therefore may have been viewed as self-serving for the research community and may not have been seen as an integral part of our changing intergovernmental relations.

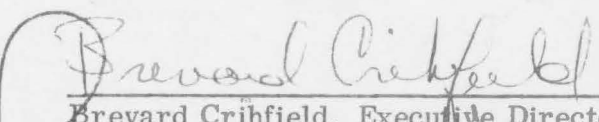
We therefore request that the Advisory Commission on Intergovernmental Relations undertake a study which would assess the following:

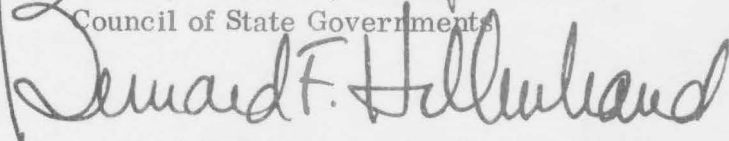
1. How well Federal R&D programs support decision-making and problem-solving activities of state and local governments.
2. The current capacity of state and local organizations to utilize Federal R&D results.
3. Ways that Federal R&D might strengthen state and local operations and reinforce current Federal policies and programs to decentralize and devalue Federal operations to the state and local levels of government.
4. Recommendations for strengthening the intergovernmental uses of research and development.

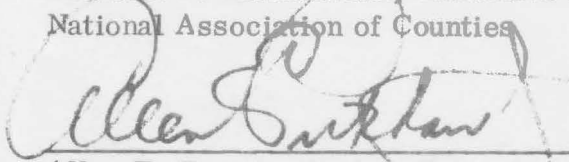
We believe that most of the basic information necessary to conduct this analysis is available from the Office of Intergovernmental Science Programs and the National Science Foundation and that very little, if any, additional data collection will be necessary. This information, in our opinion, has not been properly examined in any intergovernmental forum which has the necessary state and local participation makeup to assess the best options for making research and development a more useful tool in the conduct of governmental operations.

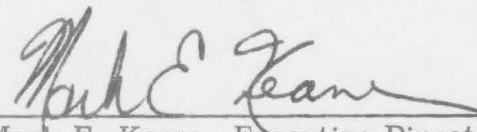
We hope that you will look favorably upon this request, and our organizations will be most pleased to work with you in order to make this a beneficial effort.

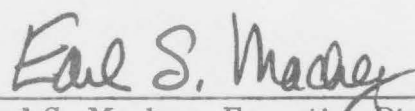
Sincerely yours,

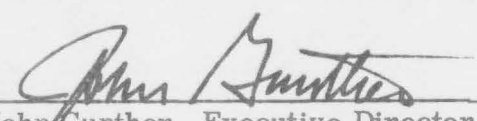

Brevard Crihfield, Executive Director
Council of State Governments


Bernard F. Hillenbrand, Executive Director
National Association of Counties


Allen E. Pritchard, Jr., Exec. Vice Pres.
National League of Cities


Mark E. Keane, Executive Director
International City Management Association


Earl S. Mackey, Executive Director
National Conference of State Legislatures


John Gunther, Executive Director
United States Conference of Mayors

G



ADVISORY
COMMISSION ON INTERGOVERNMENTAL RELATIONS
WASHINGTON, D.C. 20575

August 20, 1975

MEMORANDUM

To: Wayne F. Anderson, Executive Director
and The Advisory Commission on Intergovernmental
Relations

From: Lawrence D. Gilson, Director of Policy Implementation

Subject: Implementation Activity Survey

By September most state legislatures are out of session for 1975, the Congress is approaching the end of its first term and most of the annual meetings of the national public interest groups have taken place. The timing therefore seems right to provide a selective review of some of the implementation activities conducted by staff over the past several months. Following is a cataloging intended to be suggestive of the range of activities in which staff engaged as it sought to achieve the widest awareness and consideration of Commission positions.

This general survey might be looked at in conjunction with the implementation reports prepared for each of the past few Commission meetings. Those earlier reports dealt in somewhat greater depth with specific implementation efforts such as staff activities at national public interest group meetings and staff responses to requests for technical assistance in the states.

Federal Level

House Intergovernmental Relations Subcommittee Hearings- ACIR's executive director and assistant directors testified on the Federal and State Aid Systems at the subcommittee's July hearings. This series of hearings on "Fiscal Relations in the American Federal System" provided background preliminary to the subcommittee's consideration of revenue sharing and countercyclical aid.

Congressional Budget Process- ACIR staff has worked informally with staff of the Senate and House Budget Committees and with the Congressional Budget Office as those new bodies have set up their procedures and worked through the first new budget cycle.

Congressional Bill Referrals- ACIR regularly receives requests for a critique of federal legislation either introduced or under consideration. These requests come primarily from Congressional Committees or from the Office of Management and Budget on behalf of federal agencies. Staff reactions based on firm Commission policy cite the policy. Reactions based on general ACIR positions and/or staff views are labeled accordingly.

Various Congressional Hearings- Staff monitored several Congressional hearings with a clear intergovernmental significance. They included general hearings on the state of the economy, hearings on countercyclical aid, budget priority hearings, and program oversight and renewal hearings dealing with the Appalachian Regional Commission and other groups.

State Level

Requests for Technical Assistance- ACIR received requests for assistance involving substantial staff follow-up from at least 22 states during the first eight months of 1975. Meeting these requests frequently involved preparing specially tailored material on a state's problems, modifying model legislation, or preparing and/or presenting testimony. Issues on which the staff received the most requests include county home rule, city-county service consolidation, local sales and income taxes, circuit-breaker property tax relief, and state level ACIRs.

Nevada Consolidation Law- ACIR staff worked with the Legislative Counsel Bureau, key state legislators and staff from the Nevada associations of cities and counties to develop the concept, prepare legislation and provide supporting materials for a consolidation of Las Vegas and surrounding Clark County. Such a consolidation was passed by the legislature and signed by the Governor earlier this year. It is certainly the largest merger since the consolidation of Indianapolis and Marion County. Staff is also involved in ongoing efforts in Nevada to create a State ACIR and to deal with some problems relating to the county provision of urban services to unincorporated areas.

South Carolina Optional Forms Law- The 1975 session of the South Carolina legislature enacted a law governing the structure of county government and, in some ways, expanding the residual powers of counties. ACIR staff conferred with the Legislative Counsel at the drafting stage of the bill and during the legislative process in order to make maximum use of court-tested language and in order to help provide a multi-state perspective on the issues involved.

Iowa Home Rule and Local Optional Tax Deliberations- Last winter ACIR staff testified before the Iowa Legislature's Interim Committee on Counties on the broad range of county funding and modernization problems. That testimony and resulting follow-up led to either testimony or to submission of a statement on County Home Rule and Local Optional Tax bills. Beyond these public hearings, staff has worked with the Legislative Counsel staff and with staff directors of the Association of Iowa Counties and with the League of Iowa Municipalities. ACIR staff will be on the program of the Iowa Municipalities League's annual meeting later this month. Additionally staff is working with the newly formed interim committee on Local Government Finance as they consider property tax relief and local optional sales tax legislation for next year.

Montana Local Government Study- The new Montana constitution included a local government article (Article X) which mandated a total review of the structure and functions of local government. ACIR has worked extensively with the state-level coordinating body and, through them, with the local and regional study commissions.

National Public Interest Groups

National Governor's Conference- ACIR staff worked with NGC staff prior to the NGC annual meeting in New Orleans in June. Because the meeting's theme was "States' Responsibilities to Local Governments" the thrust was highly intergovernmental and overlapped ACIR's work in numerous respects. ACIR staff provided background resources for the basic NGC policy document presented in New Orleans. Then ACIR arranged to prepare a companion volume of suggested legislation to implement NGC policy options. The final NGC policy volume and the companion ACIR legislative volume are due to be mailed to all governors about October 1. In addition ACIR supplied materials for use by NGC at their training sessions for newly elected governors.

Council of State Governments- As in past years, ACIR staff served on both the screening and the full bodies of the CSG Committee on Suggested State Legislation (SSL). ACIR was able to place eight of its model bills in the upcoming volume. The ACIR bills deal with county modernization and local sales and income taxes. ACIR staff was on the program of the CSG New England Region's Session on circuit-breaker property tax relief.

National Conference of State Legislators- ACIR's Executive Director and/or implementation staff met with the Government Operation Task Force of the NCSL Intergovernmental Relations Committee on at least three occasions this year. These task force meetings are held to identify major intergovernmental problems and to develop proposed NCSL policy positions for presentation at the annual meeting. Major areas of NCSL interest with which ACIR staff has been involved include local sales and income taxes, the state's role in preventing or dealing with local government financial emergencies, and substate regionalism. In addition, ACIR staff has been on the program of NCSL training sessions dealing with transportation and general fiscal problems.

International City Management Association- The executive director and the assistant director for taxation and finance co-authored an article titled "Slumpflation- Its Effect on Local Finances" for ICMA's magazine "Public Management" and another ACIR staff member has written an article on ACIR's new regional transportation recommendations for their October issue.

National Association of Counties- ACIR staff has contributed several articles to the NACo "think piece" newspaper supplement Outlook when the supplement has been devoted to substate regionalism, County Home Rule, and the ACIR Conference on American Federalism in Action. In addition, ACIR staff periodically reviews areas of common interest and state activity with NACo staff.

Other Organizations- ACIR has had numerous other opportunities to make presentations on subjects where the Commission has made major recommendations, especially on regional transportation, revenue sharing and various aspects of substate regionalism. Staff members have made major presentations on these subjects to ASPA, ASPO, MFOA, NATA, NARC, and NCSL (National Civil Service League).

Publication Program

Regular Publications- ACIR staff has recently reassessed its program of producing Information Bulletins, Congressional Watch, Information Interchanges and Action Agendas. As a result of that review, all of the above information vehicles will be folded into two publications -- a quarterly magazine called Intergovernmental Perspectives and monthly Information Bulletins. The quarterly will be mailed to the entire ACIR mailing list. In addition to regular features dealing with Washington activities, ACIR research in progress and recently released publications, each issue will be built around a theme selected to highlight recent ACIR research and recommendations. The first issue will be distributed in October.

Mailing List Revision- While it is hoped that by mailing the quarterly discussed above to the entire ACIR mailing list, we can substantially meet the concern from some people that they "never get" ACIR publications, it is still necessary to review the mailing list itself to be certain that it is up to date, sufficiently comprehensive and focused toward the most appropriate groups. Such a comprehensive revision and updating process is underway. A questionnaire was sent to all those currently on the mailing list, the list has been converted to a computer-based system permitting more accurately targeted audiences, and new categories of people (such as the membership of key state legislative committees) are being added. Naturally, a culling process must be a part of the total update and that is underway as well.