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FINANCING PUBLIC SERVICES IN VIRGINIA: WHERE THE MONEY COMES FROM AND WHAT IT BUYS

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Promises to eliminate the car tax, the "death tax," the sales tax on food, and to reduce income taxes all meet with approval. Threats to reduce services and social security and Medicare payments all meet with disapproval. How to reconcile these public reactions is one job of government.

"Government" evokes a variety of images: taxes, rules, regulations, codes, laws, the White House, the county courthouse, the state capital building, people, policemen and police cars, and schools and teachers. Government is all of these things and much more. At its core, government is a concept used to manage, guide, and structure public activities. Government was created to provide order and a range of services that people cannot effectively secure or manage individually, such as national defense, public education, highways, and public transportation.

To provide these services, government borrowed from the private sector and instituted a system of payments. This system is commonly referred to as taxation.

THE AUTHORITY TO TAX

The authority a county, town, or city has to tax is found in the Constitution of Virginia, the Code of Virginia, and legislation enacted by the Virginia General Assembly.

Constitution of Virginia, Article X, provides that real estate, mineral lands, and tangible personal property are to be taxed by local governments only. Local governments are generally precluded from levying an income tax. (In 1989, the state legislature authorized four counties and six cities to levy a local piggyback income tax on top of the state income tax. The proceeds must be dedicated to transportation needs and the tax must be approved in a local referendum. No locality has enacted the tax as yet.)

Legislation enacted by the Virginia General Assembly has a more direct impact on local governments than does Article X of the state Constitution. Each legislature over the past 20 years has produced laws that affect the rights and privileges of local governments to raise revenue. For example, the 1998 General Assembly enacted legislation that significantly altered the personal property tax as it applies to automobiles.

The Code of Virginia (Title 58.1, Chapters 30 through 39) outlines specific items of wealth and wealth-producing activities that may be taxed by local governments.

LIMITATIONS ON THE AUTHORITY TO TAX

Local governments have a number of limitations on their taxing authority. Six of the most important are

1. The United States Constitution prohibits taxes that would violate fundamental freedoms or impede interstate or foreign commerce.
2. Federal and state laws exempt certain kinds of property from taxation, for example government property, churches, and non-profit organizations.
3. Localities possess only the taxing powers authorized by state law (see *Horizons* "Variations on 'Mother May I?': Dillon's Rule," November/December 1998).
4. The Virginia Uniform Charter Powers Act (UCPA) provides cities and towns with a broad range of taxing authority that can only be exercised if the powers are incorporated within the individual city or town charter.
5. The constitution requires that each parcel of real property within a jurisdiction be taxed at the same rate.
6. All real property must be assessed at fair market value.

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REVENUE DIFFERENCES BETWEEN COUNTIES AND MUNICIPALITIES

Virginia's network of 325 local governments was not created equal. Shires were formed soon after the founding of the Virginia colony. They were empowered to perform duties considered essential to the administrative needs of the Colony and the Crown. Chief among these duties was the collection of taxes and the provision of law enforcement services in the person of a sheriff. Shires ultimately became counties.

As Virginia gained population and communities became larger, the Crown, the Royal Governor, and ultimately the state itself sanctioned the creation of new forms of local government: villages, boroughs, towns, and cities.

A town or city, once created by the state legislature, is granted a charter. The charter outlines the various powers, duties, and responsibilities, including taxation, the city or town is expected to perform. Because towns and cities are created at the request of a community of residents, the state legislature has chosen to give municipalities taxing authority that is somewhat different from that of counties. The UCPA gives municipalities the power to raise, by taxes and assessments, the funds needed to finance local government services demanded by community residents. Using this authority, many Virginia municipalities have levied taxes on cigarettes, lodgings, meals, admissions, and other services and activities. Counties are limited, unlike municipalities, in the amount of revenue that can be raised through selected taxes, licenses, and fees.

SOURCES OF LOCAL REVENUE

Property Taxes

Taxes on classes of property are the most important sources of local revenue in both counties and municipalities. Real property tax accounts for 41 percent of all dollars raised by Virginia cities and counties. When all four categories of local property tax (real, personal, machinery and tools, and public service corporations) are combined, the total accounts for over 60 percent of local revenue collected (1999 Auditor of Public Accounts).

Tangible real property tax is composed of land and buildings or other permanent fixtures and improvements. Virginia law requires that localities assess the value of real property at least every five years and that the assessment be at fair market value. Local governments have the authority to change the tax **rate** applied to real property. Use-value assessment of agricultural, horticultural, forestal, and open space lands and Agricultural and Forestal Districts apply to counties and municipalities that have enacted the appropriate local ordinances.

Tangible personal property tax consists of assets not permanently attached to real estate. This tax is applied to a broad range of items such as motor vehicles, mobile homes, business furniture, boats, recreational vehicles, computer equipment, aircraft, farm machinery, and farm livestock. Local governments are allowed to set their own rates for the tax. As might be expected, assessment ratios and valuation methods vary significantly across the state.

Machinery and tools tax is a form of personal property tax. All machinery and tools used in manufacturing, mining, processing, radio and television broadcasting, dairy operations, and laundry and dry cleaning must be valued by depreciated cost or a percentage of original total capitalized cost excluding capitalized interest. The tax rate may not exceed the rate imposed on general personal property, but some localities use lower rates as part of an economic development strategy.

Public Service Corporations tax is imposed on the corporation's real property (original cost less depreciation) and a similar tax on the corporation's tangible personal property. The value of the property of public service corporations, including electric, telephone, water, heating, and pipeline distribution companies is assessed annually by the State Corporation Commission. The locality sets the tax rate.

Sales and Use Tax

A local sales and use tax is levied by every city and county in Virginia at the maximum rate of 1 percent. It is collected by the state (along with the 3.5 percent state sales and use tax) and then returned to localities based on point of sale. One-half of the 1 percent of the local sales tax is shared equally among the towns within the county boundaries; the county keeps the other 0.5 percent. The remaining 3.5 percent is distributed as follows: 2 percent is deposited in the state general fund; 1 percent is distributed to cities, counties, and towns for the operation of public schools; and 0.5 percent is deposited in the Transportation Trust Fund to help pay for highway construction and maintenance, ports, airports, and mass transit.

Business, Professional, and Occupational Licenses (BPOL) or Gross Receipts License Tax

Each local government may levy a local license tax on businesses, trades, occupations, and professions, although some types of businesses are exempt from the tax. The BPOL tax has four classifications: contractor, retail, business services, and professional services. Each classification has a maximum tax rate set by state law. Localities that do not impose a BPOL tax may levy a Merchant's Capital Tax. Generally, cities and towns rely on the BPOL tax, while about half the counties impose the Merchant's Capital Tax.

Merchant's Capital Tax

If a county levied a BPOL tax, it cannot also levy a Merchant's Capital Tax. The types of businesses on which this tax are generally levied are repair services, daily rental property, and pharmaceutical wholesalers.

Utility License Tax

Each local government is authorized to impose a license tax on public service corporations, including telephone, telegraph companies, water, heat, light, and power companies. The tax is capped at a rate not to exceed 0.5 percent of the gross receipts resulting from sales to consumers in the respective locality. This tax is imposed on public service corporations in lieu of the BPOL tax.

License Taxes and Fees

Virginia's local governments may levy certain license taxes on a variety of items. Chief among the items and activities being taxed are motor vehicles, trailers, semi-trailers, food and beverage, E-911, wireless E-911, bank stock, cigarettes, video programming, and alcoholic beverages. However, all licenses and fees are not available to all counties or all towns. In some cases, local voters must approve the license or fee before the locality can use the revenue source.

Service Charges/User Fees

Revenue from service fees is linked to a particular service with an identifiable end user. Examples include refuse collection, water and sewer services, and recreation programs.

Inter-Governmental Revenue

Revenue from the Commonwealth in the form of state aid is an important source of revenue for local governments. It includes financial assistance for governmental functions such as education, social services, health, libraries, and jails; cost-sharing salaries and expenses of constitutional officers, such as judges, sheriffs, and Commonwealth attorneys; and state returns from taxes and fees local governments collect for the state, such as motor vehicle sales tax and Alcoholic Beverage Control (ABC) profits. These funds are returned according to a General Assembly established distribution formula, which can change annually.

Revenue from the Federal Government in the form of federal categorical grants for such projects as water and sewer, economic development, and mass transit are an important source of revenue for many local governments in Virginia. Much of the revenue that arrives from the federal partner is funds that first pass through the state government.

WHAT THE REVENUES BUY

Community Development includes the operation and maintenance expenses for planning and community development, environmental management, and local expenditures for Virginia Cooperative Extension.

Education includes operation and maintenance expenses for school instruction, school administration, pupil attendance and health, pupil transportation services, school food services and other non-instructional operations, and contributions to community colleges.

General Government Administration includes the operation and maintenance expenses for legislative functions like the Commissioner of Revenue's office, the Treasurer's office, data processing, motor pool, central purchasing and central stores, and risk management/self insurance.

Health and Welfare includes operation and maintenance expenses for health, mental health and mental retardation, welfare, and social services.

Judicial Administration includes the operation and maintenance of courts and legal services.

Parks, Recreation, and Cultural includes operation and maintenance expenses for parks and recreation, public libraries, and cultural enrichment activities.

Public Safety includes the operation and maintenance of law enforcement and traffic control, fire and rescue services, correction and detention, inspections, and other protection services.

Public Works includes the operation and maintenance of highways, streets, bridges and sidewalks, sanitation and waste removal, and general buildings and grounds maintenance.

1999 REVENUE AND EXPENDITURE PATTERNS

General property taxes (61 percent) are the primary source of local revenues throughout Virginia. Other local taxes (23 percent) and charges for services (9 percent) combine to produce 93 percent of all local revenue. In fiscal 1999, nearly 64 percent of all revenue was raised at the local level. The Commonwealth contributed another 31 percent and the federal government 5 percent.

The leading local government cost is education at 55 percent. Public safety (14 percent), health and welfare (11 percent), and public works (7 percent) combined produce a third of all local government maintenance and operation expenditures—not unexpectedly since local governments are required to address the health, safety, and general welfare of their citizens.

OBSERVATIONS AND SUMMARY

No one likes to pay taxes. Most people complain when new taxes are imposed or existing taxes are increased. But without taxes, there would be no public services. One of the most difficult challenges facing local governments across the Commonwealth is the task of raising revenues to pay for public services and programs. Who pays, how much they pay, and what is received in return are significant, complex public policy issues.

Virginia's local governments rely heavily on the real property tax as a source of revenue. In like fashion, education is one of the leading expenditures for local governments throughout the state. With revenues from Federal and state funds that have declined over the past 20 years from 43 percent to 36 percent of total local budgets, localities are being forced to generate an increasing amount to pay for the services and programs they provide (Auditor of Public Accounts). Localities are limited in their options to raise local revenue for the services they provide. As a result, the state legislature created the Commission on Virginia's State and Local Tax Structure for the 21st Century to study the taxing structure for localities. The Commission examined a number of issues surrounding the ability of local government to appropriately fund required services. The issues raised and the recommendations of the Commission should be considered carefully and objectively if localities are to meet the increasing demands for services placed on them. (*Report of the Commission on Virginia's State and Local Tax Structure for the 21st Century* can be found at *http://www2.institute.virginia.edu/taxstudy/FinalReport.pdf*).

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