

Strains in Local Government's Iron-clad Link to the Property Tax?

Alan Raflo

"I think it is inevitable--and it is only a question of time--that the property tax will be repealed, either by the voters who reject the levels [of taxation] you have to attain to support education or by the people who recognize that in a changing economy the taxation of one particular form...of wealth and allowing other forms...to escape taxation is...utterly discriminatory."

--An Oklahoma state senator

"Virginians would do well both to anticipate an assault in our state on property taxes for school funding, and to begin laying the groundwork for a sound alternative."

--Roanoke Times & World-News editorial

These two comments cut straight to the heart of a debate being waged nationally on the use of property taxes. The comments are strikingly similar. But even more striking is that the Oklahoma legislator's comment was made at the "Conference on State Financing of Public Schools" held in Washington, D.C. in 1971--23 years before the April 1994 editorial!

Debate, and indeed dissension, over the reliance on property taxes to finance local governments are by no means new. Nor has the difficulty of the issues involved diminished with age. Specifically, the reliance on the property tax is closely related to two complex problems: 1) how to ensure stable and equitable funding for public schools; and 2) how to meet increasing demands for state and local government services without resorting to tax increases that are politically or fiscally unbearable. Because I suspect that nearly every jurisdiction in Virginia faces one or both of these problems, this article looks at some basic

questions and answers on the use of the property tax by Virginia localities. If it seems that more questions are raised than answers given, that is a good indication of the complexity of the "iron-clad link."

(Note: The May/June 1994 issue of *Horizons* noted that a REAP Policy Paper on this property taxes would be forthcoming. This article is in lieu of a Policy Paper.)

1. How do Virginia's local governments get their revenue?

According to the 1994 *Comparative Report of Local Government Revenues and Expenditures* for Fiscal Year 1992-93 (from the Virginia Auditor of Public Accounts), the following sources of local tax revenue were used by some or all of Virginia's cities and counties in that fiscal year:

Property Taxes

- Real
- Personal
- Public service corporation
- Other (includes machinery and tools, merchants' capital, and penalties and interest collected on property taxes)

Nonproperty Taxes

- Admission/amusements
- Bank stock
- Business license
- Coal severance
- Local option sales (one percent of sales, collected along with the state 3.5-percent sales tax; used by all localities)
- Motor vehicle license
- Recordation and wills
- Coal road improvement
- Consumer Utility
- Franchise license
- Hotel and motel room
- Restaurant food
- Tobacco

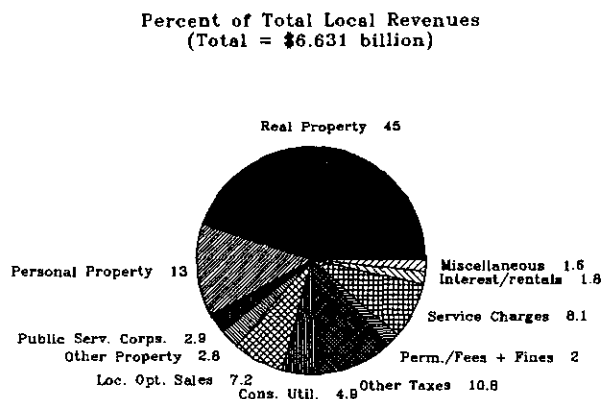
Other Revenue Sources

- Fines/Forfeitures
- Interest/rentals
- Miscellaneous
- Permits, privilege fees and regulatory licenses
- Service charges

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Let's take a look at the relative contribution of these sources of local revenue. Figure 1 shows the percentage contribution of each of several major tax categories to *total* local government revenue in Virginia in FY 1992-93. These percentages are based on the statewide total of *locally generated* revenues. Relative reliance on these sources varies considerably among Virginia localities, but the figure gives an accurate impression: Property taxes are "the dominant source of tax revenue for local governments" in Virginia, as well as throughout the nation, as John Knapp and Tyler Fox note in "Local Taxation in Virginia."

Figure 1. Local sources of revenue in Virginia, FY 1992-93 (percentages of statewide total of local revenues; percentages vary among localities).



Source: *Comparative Report of Local Government Revenues and Expenditures, 1994.*

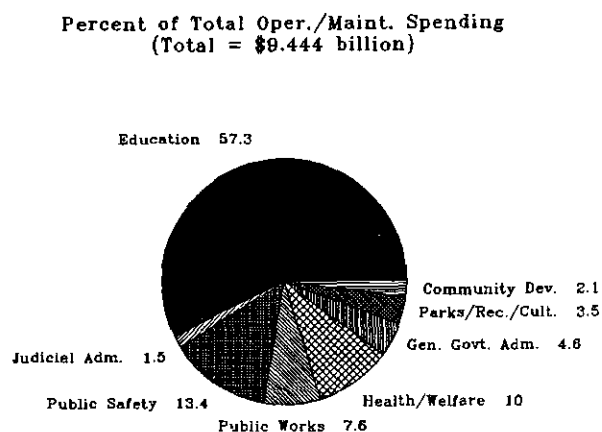
This summarizes the existing local revenue sources in Virginia. Keep in mind, however, that localities also receive money, for various purposes but definitely for education, from both state and federal sources.

2. How do Virginia's local governments spend their revenue?

Figure 2 shows, by percentage, the major categories of *total* local government spending in Virginia in FY 1992-93. These spending percentages

are based on the statewide total of local government expenditures. The percentages spent in each category vary among localities (as do the actual amounts spent per capita). Only spending for operations and maintenance are reflected in these percentages. Capital expenses--for example, for school or other public building construction--are not included.

Figure 2. Spending percentages for Virginia localities, FY 1992-93 (percentages of statewide total of local spending; percentages vary among localities).



Source: *Comparative Report of Local Government Revenues and Expenditures, 1994.*

The message of Figure 2 is no surprise to anyone who has watched a local board of supervisors or city council struggle to fund a local school budget: Public schools are, in most cases, by far the largest local government expenditure. Consequently, questions about the property tax inevitably become questions about public school finance, and vice versa. Let's, therefore, focus the discussion on property taxes and schools.

3. Are there alternatives to the property tax to fund schools?

This is the question many people in Virginia and other states are asking (and have asked for many years). In fact, an April 29, 1994 seminar, sponsored by the weekly newspaper *Leesburg Today* with assistance from

REAP, focused on this very question. The seminar attracted citizens and local officials from across Virginia.

The short answer to the question is "yes." Figure 1 shows that other sources of revenue are legally available to localities. But, as was made clear at the April seminar in Leesburg, eliminating or reducing reliance on local property taxes to fund schools would mean one of two things: localities would have to pay the bill for public education from some other revenue source; or localities would pay a smaller portion of the bill.

Of the total local expenditures on Virginia's public schools in FY 1992-93, 50 percent came from local revenues, 44 percent from state revenues (the state's general fund plus funds from the one percent of the state sales tax devoted to education), and 6 percent from federal funds. This funding split is comparable to that occurring in many other states, although the proportions are quite different in some states (Table 1).

Table 1. Sources of funding for public schools in the United States, FY 1990-91.

Revenue Source	50-state Average	Range (50 states)	Virginia (FY 92-93)
Local	44%	2%-89%	50%
State	49%	8%-91%	44%
Federal	7%	3%-17%	6%

Source: Adapted from a map in *The Christian Science Monitor*, March 28, 1994. Original source: *Public School Finance Programs of the United States and Canada, 1990-91*.

At the April seminar in Leesburg, Suzette Denslow, deputy director of the Virginia Municipal League, summarized the financial challenge if state-level revenues were used to replace the property tax to fund public education. Using data for FY 1991-92, she made two crucial points. First, the amount of money generated by the local property tax in that fiscal year was nearly three-quarters the amount generated by the state income and sales taxes. Thus, a large percentage increase in state taxes would be needed to compensate for property tax revenues. Second, state revenues can vary from year to year, as the state budget shortfalls of the early 1990s made painfully clear. Property taxes, on the other hand, are noted for being a *relatively* stable revenue source.

Are there other options at the local level? In their article "Local Taxation in Virginia," Knapp and Fox

contend that Virginia localities have two untapped sources of local tax revenue: 1) a local income tax; and 2) an increase in the local sales tax or an expansion to sales currently exempt (for example, certain services). Under the "Dillon Rule," which applies in Virginia, both of these options would require a grant of authority from the Virginia General Assembly.

Knapp and Fox point out, however, that taxes are not the only way to generate additional revenue or to replace an existing revenue source such as property taxes. They cite a 1987 national opinion poll by the Advisory Commission on Intergovernmental Relations (ACIR), in which charges for specific services were the top choice (chosen by 33 percent of respondents) for collecting additional local revenue. In the same ACIR survey, local sales taxes were preferred by 20 percent of respondents, no tax increases by 17 percent, local income taxes by 9 percent, and local property taxes by 9 percent. As Figure 2 shows, however, local service charges generated approximately \$537 million in FY 1992-93, while the four categories of property tax (real, personal, public service corporation, and other) generated approximately \$4.2 billion, almost eight times as much.

4. What is being done or discussed in other states?

Michigan provides the best-known recent case of movement away from the property tax. In 1993, the Michigan legislature eliminated the property tax as the main source of public school funding. Then, in a March 1994 referendum, voters chose to increase the sales tax from 4 to 6 percent and the cigarette tax from 25 cents to 75 cents per pack, instead of raising the state income tax, the other option presented by the referendum. Under the new financing arrangement, the state will guarantee a minimum of \$4,200 per pupil (as of 1994, Michigan's poorest districts spent less than \$3,200 per student, one-third of the amount spent by the wealthiest districts). The plan places control over most education spending at the state level. Localities will be able to set up private, non-profit organizations to solicit additional money for local schooling, but the state apparently will still exercise ultimate control over the level of spending.

How has the new Michigan plan worked? A recent newspaper article (*Christian Science Monitor*, October 21, 1994) reported several problems. According to local officials, state financing is "inadequate and uncertain," there is concern that the state might exert more power over local school curricula, and the disparity in per pupil spending among school districts is still wide. The state is providing the money for the baseline level of \$4,200; however, local districts are now required to pay more for other costs, including employee pensions. On the other hand, the chief deputy treasurer for the state of Michigan is quoted as

saying that, although "complete equality" of funding has not been achieved, the system is "more equal than before the reform." He also maintains that "state taxes are more predictable and reliable [than the previous system of local property tax reliance]."

Michigan is only one of several states wrestling with education funding. Here are some other examples, from articles in the March 14 and March 28 issues of *The Christian Science Monitor* and from "The Property Tax Predicament" by Scott Mackey.

● **Illinois**--The 1994 Democratic gubernatorial candidate, Dawn Clark Netsch, proposed increasing the personal income tax by 42 percent and lowering property taxes. (Ms. Netsch was defeated in the November 8 election.)

● **Massachusetts**--The state's supreme court ruled in June 1993 that the state's property-tax-based school finance system had failed its constitutional duty to provide an adequate education for all public-school students.

● **Minnesota**--The Coalition for Education Reform and Accountability, created in 1993 by the state legislature, is expected by early 1995 to report on a "rethinking" of school finance.

● **Rhode Island**--As of March 1994, the legislature and the governor were reviewing a proposal by the state Board of Regents for \$265 million to reduce reliance on funding schools from property taxes. A uniform tax rate for all communities was part of the proposal. This followed a court ruling that the state's previous school-aid formula to reimburse "property-poor" school districts was unconstitutional.

● **South Carolina**--In 1994, legislation was proposed but defeated to eliminate the use of property taxes for school operations. The sponsor of the legislation, state Representative Billy Boan, has stated that he expects the issue to be brought up again in 1995.

● **Vermont**--In February 1994, the state House of Representatives passed a plan to replace local property taxes with local income taxes and a statewide tax on nonresidential property and vacation homes. The state Senate passed a bill that did not include the statewide property tax or a local income tax. Both bills died in session when the two houses could not reconcile the different proposals.

● **Wisconsin**--In 1994, the state legislature approved a proposal to provide enough state aid that property taxes for most school districts could be frozen or reduced for 1994-95.

5. What are the ramifications of possible alternatives?

Changing the reliance on property taxes for local government finance would have a number of possible ramifications. The following is an overview of several major areas that state and local policymakers and citizens should consider. (These areas deserve considerably more attention than is possible in this article.)

● **Traditional roles of local government in Virginia.** In Virginia, the link between local property taxes and local public schools goes back to a state constitutional division of responsibilities between the state and localities (see the September/October 1992 issue of *Horizons*). Simply put, the 1928 amendment gave localities express use of property taxation to fund public schools, while the state reserved for itself other taxes to fund other responsibilities, primarily (at the time) road-building. But in 1994 Virginia, and Virginia's localities, are vastly different, as are the demands on government. The outgoing president of the Virginia Association of Counties recently said that Virginia's "most pressing need is a whole revamping of the local government system" (*Roanoke Times & World-News*, November 17, 1994, p. C7). Is the existing system of governmental responsibilities and financing in Virginia adequate for the next 5, 10, 50 years? This question is fundamental to evaluating the role of the property tax.

● **Fairness of financing among localities.** This is the question of disparity in per pupil spending among school divisions, an issue that has received much attention in Virginia (and in over 20 other states). Closely tied to the use of property taxes, this issue remains to be solved. (For more information on this topic, see the REAP Policy Paper entitled *The Disparity Issue in K-12 Education in Virginia*.)

● **"Beneficiaries pay" principle.** Much of the disagreement over property taxes results because some of the people who pay for public education do not necessarily receive, or do not believe they receive, direct benefits from that spending. The economic concept known as the "beneficiaries pay" principle would hold that public education should be paid for by those individuals or institutions that "capture the benefits" resulting from public education (see the January/February 1992 issue of *Horizons*).

Because people are free to take their education and move to another locality (and they often do), a locality that invests in a child's education may not receive the benefits of the investment. In contrast, an investment in, say, water or sewer facilities or roads would of course provide some return to the locality where the facilities or roads were built. At the individual level, the beneficiaries pay principle underlies the reluctance

taxpayers without school-aged children may have to pay for public schools. At the governmental level, the same principle would underlie arguments for funding public education at the state level, where benefits are more likely to be captured. (Substantial funding of public schools at the national level, where benefits are even more likely to be captured, is probably neither fiscally feasible nor politically acceptable.)

●**The relationship of property ownership to the "ability to pay."** Discussions of school funding, and the disparity in per pupil spending among localities, almost invariably involve comparisons of local property tax rates. Localities with relatively low property tax rates are often criticized for putting forth a low "revenue effort." But an important consideration is whether "revenue capacity," or the ability of a locality's citizens to pay taxes, is accurately reflected by the level of taxable property. (Research sponsored by REAP has looked at this issue in some detail. More information is provided in the report, *Paying for Schooling in Virginia: A Citizen's Guide to School Finance*).

●**The stability of the revenue source.** The property tax is in some ways a more stable source of revenues than state income or sales taxes. But, over time, property tax revenues can also be unstable. This was the hard lesson learned by northern Virginia localities during the recession of the early 1990s.

●**Operating expenses vs. capital expenses.** As noted above, the figures cited here for the use of property tax revenues are for operation and maintenance only. The figures do not include money for construction of new school buildings, often a substantial expense in localities where the population is increasing. Usually new school construction is financed by selling bonds following voter approval in a local referendum; this finances the projects over several years, resulting in only a relatively minor impact on the property tax rate in any given year. Nevertheless, real money has to be spent, and, like annual operating budgets, school bond referenda can generate contentious discussion of who will pay, how much, and for whom.

●**Overall level of taxation.** According to the June 1, 1994 issue of the *Christian Science Monitor*, the average U.S. taxpayer will pay 34.2 percent of income in federal, state, and local taxes, compared to 32.5 percent in 1984. Property taxes accounted for about 10 percent of total taxes nationally in 1994. The "fastest growing taxes by far over the past decade have been local," notes the article. No one likes higher taxes, but what taxpayers probably like even less is inefficient use of tax dollars. Would shifting the balance between local and state funding for public education result in any efficiencies that could lower the overall tax burden, or would just the opposite be true? This is a question we might all ask the General Assembly to explore.

●**Local control of schools.** "What is [replacing the property tax with a tax collected by the state] going to do to our decision-making ability?" asked Virginia Delegate William Mims (R-Loudoun) in the April 27 issue of the *Loudoun Times-Mirror* (published in Leesburg). And, if local control of school decisions were reduced, would voters choose that for the sake of reduced property taxes?

●**Educational effectiveness.** This issue is closely related to concerns over local control of schools and the potential impact of alternative financing methods on local control. Arguments about what results in—in fact, about what even constitutes—good-quality local schools are complicated, long-running, and often heated. Such arguments will in all likelihood continue to be part of the debate over the use of local property taxes for public school funding.

6. Why should you care?

Local governments in Virginia confront at least two serious financial problems. The first problem is the disparity in per pupil spending among Virginia's localities. The second problem is the increasing difficulty that more populous localities are having in meeting the demands for services without politically unacceptable tax increases. One area of common ground between these problems, and among all localities, is the large role of the property tax in local government finance.

Are there alternatives to heavy reliance on the property tax, and are they needed in Virginia? If property taxes affect you—if you pay taxes; use state or government services; go to, work in, or have children in public school; make use of public school facilities; or employ workers educated in Virginia's public schools—then you can help decide.

References and Further Reading

(All papers marked with "*" are available from REAP.)

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CORRECTION

In the September/October 1994 issue of *Horizons*, page 3 listed several organizations that participated in an advisory board set up to help the Virginia Department of Environmental Quality develop a new Virginia Pollution Abatement "general permit." The Virginia Department of Agriculture and Consumer Services, which played a major role in the work of the advisory board, was inadvertently omitted from the list. *Horizons* apologizes for the error.

NOTICES

*Did you notice *Horizons'* new front-page look?!

*REAP Policy Paper #5, *GATT and Agriculture: Gains and Promise!*, by Nicole Fatseas and David Orden, has been published. The paper was mailed to all regular *Horizons* recipients just before Thanksgiving. Additional copies may be requested from the Virginia Cooperative Extension Distribution Center, Landsdowne Street, Blacksburg, VA 24061-0512; (703) 231-6192. Please request 1994 publication 448-305/REAP P005.

*"Agri-Celebration '95" will be held January 12-14, 1995, at the state fairgrounds in Richmond. According to its hosts, Atlantic Rural Exposition, Inc. and the Virginia Agribusiness Council, the event "is a consolidated promotional presentation of Virginia's...agriculture, joining all agricultural sectors and associations for the purpose of providing information, education, and entertainment." Over 40 agricultural groups have been invited to participate. For more information on Agri-Celebration '95, contact Clay Roberts, Atlantic Rural Exposition, Inc., P. O. Box 26805, Richmond 23261-6805; (804) 228-3216.

For more information, please contact REAP, Department of Agricultural and Applied Economics, Virginia Tech, Blacksburg, VA 24061-0401; telephone (703) 231-9443.

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