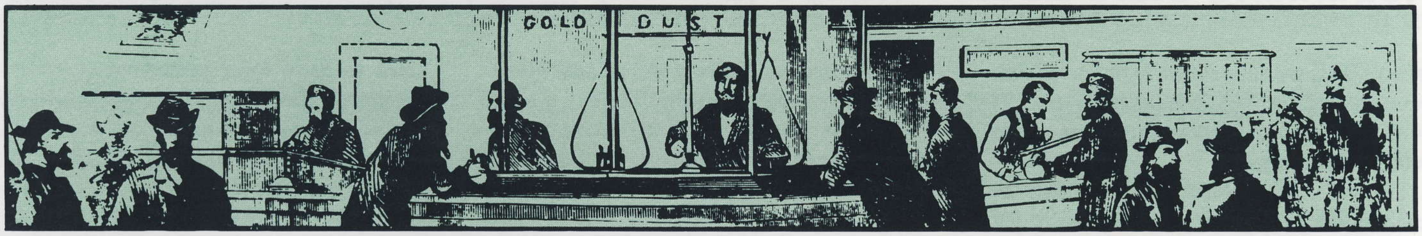

THE FISCAL LETTER

A Bi-Monthly Report on Government Finance Issues in the States

National Conference of State Legislatures
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William T. Pound, Executive Director
March/April 1991, Vol. XIII, No. 2
ISSN 0197-288XI

State-Local Finance: Rethinking Service Delivery and Taxing Authority

By Robert Strauss

Now that Operation Desert Storm is over, much of the public's attention could easily be devoted to the deepening fiscal problems of our states, school districts, and municipalities. On a national income accounts basis, the state and local sector deficit is running at an annual rate of $30 billion, after adjusting for public pension revenues.

Two sorts of problems confront the states this year: one, the immediate problem of finding the revenues to finance current service budgets; and two, the festering problem of how to finance, over time, the growing service needs at the state and local level. My purpose here is to provide some ideas on the longer term problems.

I suggest that the time is overdue for the states to reexamine how state-local services are financed and to redefine the proper relationship between service delivery and taxing authority. In periods of ample federal and state revenues, this would not be a priority because it is so thorny; however, because the fiscal future looks so bleak, we need to start processes that will result, by the close of the decade, in a more rational allocation of service delivery and taxing authority.

The key to this reallocation involves giving local school districts the authority, over time, to replace property taxes at least in part with local income taxes. School equalization formulas should be restructured toward equalizing by family income instead of per-pupil property values. Also, state assistance to municipalities with concentrations of exempt property, commuters, and the poor should be provided through new systems of revenue sharing and grants-in-aid.

Tackling immediate revenue emergencies and fundamental restructuring in the same legislative session is not easy and is therefore unlikely. One way to address these structural issues is by starting processes of study and consensus building through commissions and joint executive-legislative study groups that would report back in more auspicious times.

Four Principles to Improve State-Local Financing of Services

Our state-local institutions reflect a thicket of governments and revenue sources invented in the 19th and early 20th centuries. Were we to start anew with a clean piece of paper, we would do well to assign service delivery and financing responsibilities in line with a few simple, normative principles.

Principle 1: Financing methods should be matched with the nature of services provided at the state and local level. For services with clear beneficiaries, fees and levies which approximate the benefits enjoyed should be used. This principle argues for financing municipal services through the local property tax and user fees.

While some might like to apply this principle to education, our societal values argue for broader support of education in recognition of the fact that we have, at least traditionally, believed that education has many intangible benefits to society that deserve support from all with the ability to pay.

There are two implications of this analysis that relate to school finance: first, there is a need for a strong state role in equalizing differing abilities to pay between poor and rich school districts. Second, both state and *local* financing instruments should be based upon ability to pay taxes (e.g. income and/or

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sales). This would require a major adjustment in local school finance since over 95 percent of all local school funds are raised with the property tax.

The reliance on local property taxes to fund education has been problematic for several reasons. First, revenues are raised from taxpayers with no direct stake in the quality of our schools. Second, compared to a local income tax, the property tax is burdensome on the elderly in some parts of the country and can create widespread resentment between grandparents and grandchildren. Finally, regions with declining property values or stagnant economic growth must constantly increase tax rates to raise enough revenue to finance growing education costs.

In the case of social welfare services, such as health and welfare, income and sales taxes based on ability to pay should be used instead of benefits-related taxes like the property tax. Some states have already moved in this direction by assuming responsibility for financing health and welfare programs at the state level. In states where such programs are financed locally, governments charged with delivery of such services (usually counties) should be given income and/or sales taxing authority. Currently, counties derive over 73 percent of their local taxes from the property tax.

A large scale shift from the local property tax to a local income tax by school districts and counties will cause a shift in tax burden from both residential property and business property to the household sector. This could become a political problem at both the state and local levels.

At the state level, a business tax increase could be used to offset the decline in business property taxes. Alternatives include a corporate income tax increase or a state sales tax increase, since in virtually every state businesses pay at least 20 percent (and often a much higher percentage) of the sales tax.

If state business tax increases are not workable, there are ways to retain the original local business/non-business share of financing the local costs of education. A homestead property tax exemption could be used to increase business' share of the property tax burden at a given millage rate. Alternatively, a classification system with a higher assessment ratio or tax rate for business property could be designed to increase the business property tax burden.

Of course, it may well be that households and homeowners should pay more of the costs of local education than the business sector. However, it is unlikely that local school boards will be very enthusiastic about replacing the local property tax with a local income tax once they discover that the household sector will pay a higher share of the local costs.

Principle 2: States should adjudicate inter-jurisdictional spillovers of service use through state grants and local taxing authority. Several sorts of spillovers occur which cause municipal overburden. Older central cities typically contain a disproportionate share of state and federal buildings, churches, hospitals, and educational institutions, all of which are tax exempt. These exemptions, which are often mandated by the state, increase the property tax burden on the remaining taxable property and encourage homeowners and businesses to migrate to low-tax suburbs.

Another source of municipal overburden is the use of municipal services by non-residents. Commuter use of services is the most frequently cited example. Again, residents pay for services used by non-residents, increasing resident tax burdens and again encouraging migration to suburbs.

Given the undesirability of such migrations, the state needs to play an adjudicatory role by providing financial aid in recognition of municipal burdens imposed by exempt property. With regard to the problem of non-resident use of municipal services, states should either enact revenue sharing or enable local municipal governments to impose commuter taxes with a credit against state personal income taxes in recognition of the state interest in such geo-attribution of service use.

Principle 3: The level of government responsible for financing a program should set benefit levels. Setting benefits should not be divorced from the level of government imposing taxes to pay for them. It also makes sense for the legislative committees that consider education finance to decide state spending levels as well.

For education and transfer payments, the benefits should be state defined and state financed. Local contributions should be based solely on ability to pay and subtracted from the baseline cost of the program. The state should finance the balance from ability-to-pay taxes. It is convenient to think of earmarking a portion of a state sales or income tax as simply providing the financing for foundation amounts of these programs.

Also, even though the state should set the baseline benefit levels and provide the financing for these types of services and transfers, it does not necessarily follow that state agencies with local offices should deliver the services. It is sometimes feasible and efficient to have local governments serve as agents of the states; however, great care should be exercised in the development of the contractual relationships for such delegated service responsibility.

An excellent case can be developed for the state sharing in part of the costs of services beyond the foundation or baseline level. In the case of education, the state and general public share an interest in increasing funding beyond the foundation level. The state could supplement local effort beyond the foundation level by setting a matching rate inversely related to personal income in the district.

Principle 4: Greater state aid should be coupled with greater local accountability. Any expansion of state aid to education or municipalities will be greeted with skepticism by many who read this. Schools and municipalities are sometimes viewed by state legislators as ungrateful teenagers who get the keys to the fiscal car, have a joy ride, and then return it to the garage with an empty gas tank. Relief occurs when one discovers there are no dents (deficits). Moreover, legislative "parents" are generally feeling rather pinched these days, so this is not a good time to think about larger "allowances."

The fundamental issue in moving towards greater aid involves ensuring that those who take the political risk of moving more resources from state capitols to local units get the proper recognition for delivering the aid increases. Let me suggest several mechanisms for ensuring that the elk hunters get credit for bringing home the elk.

First, require a public vote in each school district to accept state aid each year. Each school board would certify the vote results in a letter to the State Department of Education. An analogous requirement could be adopted for all counties and municipalities receiving state aid or federal aid that flows through the state.

Second, pass a law requiring local governments to measure and report to the public the quantities of public services provided locally with state support. For example, the requirement could include:

o the number of children in special education;

o the number of children passing and failing in each grade;

o the percentage of children who drop out;

o the percentage attending college;

o the distribution of test scores;

o the number of citizens receiving public transfer payments;

o the number of potholes filled;

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o the number of arrests, by type;
o the number of fires attended to;
o the number of complaints;
o attendance at cultural attractions (zoos, museums, etc.);
o tons of garbage collected;
o the number of licensed vehicles.

In addition to the political benefits, reporting will help citizens understand service needs and how they are met.

Conclusion

The four principles discussed above provide a framework for assessing proposed changes in the current system of financing state and local services. It is my view that the current system creates a variety of incentives that are proving increasingly adverse to both consumers of government services (the public) and the producers of such services (the executive and legislative branches of government).

While it is true that enacting some of the proposed changes will prove difficult and may not solve the malaise of the state-local sector, it is also true that avoiding these issues, and their solutions, may involve considerable political costs to both the public and government. Much complaint is heard these days that the national leadership is better at dealing with Iraq than with the deficit; however, the same complaint rings true at the state and local level. For example, there is widespread sentiment for better schools, but few are stating the obvious--that the way we finance our schools has as much to do with their success as empowerment, school choice, or other proposals for education reform. ■

Bonds (from page 3)

The Oklahoma State Bond Advisor's Office and the Louisiana State Bond Commission, with help from the National Association of State Treasurers, are pursuing the establishment of a state debt management network. The network could lead to the creation of a new organization among state debt management entities designed to share information and discuss policy and technical issues in the area of debt management. (See page 12.) ■

Taxes Slip Downward Again

By Scott Mackey

New Census Bureau figures indicate that the percentage of the nation's personal income that goes to state and local taxes fell for the second consecutive year. Preliminary figures show that state-local tax levels fell to $11.37 per $100 of personal income in state fiscal year (FY) 1990, a 1.5 percent drop from the FY1989 level of $11.55.

This national average masks considerable variation among the states. New Hampshire, with no personal income or sales tax, has the lowest state-local tax level at $8.22 per $100 of personal income. Alaska had the highest state-local tax level in the nation, $18.30 per $100 of personal income, 61 percent above the national average.

Although tax level data is useful in making regional and other general comparisons, tax levels do not always provide an accurate picture of a state's resident tax burden. Some states have the ability to export tax burdens. Alaska, for example, has the highest tax level in the nation, even though it has no personal income or sales tax. Taxes on energy companies, which are paid indirectly by energy consumers, provide the bulk of state revenues. Hawaii and other states reliant on the tourism industry also have lower resident tax burdens than tax level data would indicate.

In the 46 states reporting data to the Census Bureau for FY1990, state-local tax levels per $100 of personal income dropped below 1989 levels in 35 states, increased in 10 states, and remained the same in one. Only eight states made major tax changes in the 1989 legislative sessions, a fact reflected in FY1990 data showing small changes in tax levels in the majority of states. Only seven states experienced changes of more than five percent, and only two states had changes of more than 10 percent.

Nebraska had an 11.3 percent increase in state-local tax levels because tax cuts in 1988 and 1989 were followed by a major tax increase effective January 1990. The tax cuts reduced the 1989 base and increased corporate and personal income tax withholding in the last two quarters of FY1990 boosted that year's total. Alaska had the largest reduction in tax levels in FY1990, a 10.6 percent drop, primarily due to a court decision providing the state a $256 million windfall in FY1989.

Other states with increases above 5 percent include West Virginia (major 1989 tax increase) and Utah. States with decreases of more than 5 percent include Maine, Delaware, and Wisconsin. None of these three states enacted tax cuts during their 1989 sessions, yet state revenues grew more slowly than personal income.

Between FY1985 and FY1990, local taxes as a percentage of personal income slowly but steadily increased from the tax revolt lows experienced in the early 1980s. State taxes, on the other hand, remained remarkably steady after FY1985, hovering around $7.00 per $100 of personal income before declining to $6.84 in FY1990.

With the economy now officially in recession, a look at states' reaction to the 1981-82 recession may provide some clues about changes in tax levels in the next few years. Lawmakers resisted tax increases during 1982 sessions, but by 1983 state finances were becoming desperate and large increases were approved in many states. The resulting tax increase boosted FY1984 state tax levels by over 7 percent. It is too early to tell whether the large state tax increases approved in 1990 sessions will boost FY1991 tax levels by a similar magnitude. However, the fiscal problems facing the states in 1991 suggest that back-to-back increases in both 1990 and 1991 could exceed the magnitude of the 1983 tax increases.

With 1991 promising large state tax increases, steady increases in local taxes, and slower personal income growth, it is likely that fiscal year 1990 tax levels will represent a low water mark in state-local tax levels.

A new report from NCSL's Fiscal Affairs program, Recent Changes in State, Local, and State-Local Tax Levels (LFP #75) examines these issues in much greater detail. ■

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Editor's Note: Table 4 on the opposite page provides information on combined state-local, state, and local taxes as a percentage of personal income. State taxes are for 12 months ending June 1990. Local taxes per $100 are assumed to be the same as in 1989. Figures for Alabama, Michigan, New York, and Texas are approximations because their fiscal years do not end June 30. U.S. Average state and local levels may not add to U.S. Average combined level because District of Columbia personal income is excluded from U.S. Average state level calculation.