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FOUR OPTIONS FOR ELIMINATING PROPERTY TAXES AND FUNDING LOCAL GOVERNMENTS

Introduction

Proposals have been advanced to eliminate all local taxes other than taxes on alcohol (HR 900) and to eliminate just property taxes (the GREAT Plan).¹ This policy brief focuses on two implications of such an action. First, eliminating property taxes would eliminate most of the tax revenue of local governments and thus an alternative for funding local government has to be found. Second, eliminating property taxes would eliminate or substantially reduce local control or discretion regarding the amount of revenue that should be raised.

This policy brief outlines four options for how the State could eliminate or substantially reduce property taxes while replacing the lost local revenue and retaining local fiscal discretion. This policy brief is one of several policy briefs and reports that the Fiscal Research Center is preparing that addresses HR 900 and the GREAT Plan.

Eliminating property taxes is seen as politically desirable. There are also economic benefits from such an act, although most economists would suggest that there are good reasons for not eliminating property taxes. This policy brief does not address the advantages and disadvantages of eliminating property

taxes, but takes as given the desire to substantially reduce or eliminate property taxes.

The property tax is the main source of tax revenue for local governments (in 2005, property taxes were 69.0 percent of local government tax revenue in Georgia). More than other sources of local revenue, it allows local government to exercise fiscal autonomy or fiscal discretion. While local option sales taxes generate substantial revenue for the operating budget, local governments can only decide whether to impose such as tax at the rate of 1 percent. Local government cannot change the sales tax rate, increasing it if the local government needs more revenue or reducing it if revenues are too large. For most local school systems, the property tax is the only tax that can be used to finance operations. Not allowing local governments the authority to control the level of revenue, and thus the level of expenditures, converts local governments into the equivalent of state agencies that depend on the state to determine the level of expenditures.

If property taxes are eliminated, then it is necessary to determine how local governments will be financed.² HR 900 had a specific proposal for funding local governments, but no funding proposal has been

advanced as part of the GREAT Plan. The funding proposal in HR 900 is to give each local government a share of state revenue based on the local government's 2006 revenue. That proposal is not workable. For example, newly created cities would receive no funding under that proposal and jurisdictions that experienced an increase in population or students would get no additional funding.

For the four options presented below there are substantial details that would have to be worked out to implement any of them. Nor are likely Constitutional issues discussed. For example, Option 3 is a rebate program in which the State writes a check to the taxpayer, which may require a change in the gratuity clause.

Option 1. Reduce Property Taxes for Schools

The first option is to substantially reduce local property taxes used to finance schools, and is loosely modeled after the school funding reform in Michigan. (In Michigan, property taxes were retained.) In 2006, 57.7 percent of property taxes in Georgia were levied for K-12 education. Thus, significantly reducing property taxes for schools would reduce total property taxes by a substantial amount. Another advantage of reducing property taxes for schools is that there is a well defined state program for funding local school systems, i.e., QBE.

Under this option the state would increase QBE funding so that the average QBE grant per student was, say, \$9,000. The current required five mill contribution would be eliminated. School systems that were spending less than \$9,000 would not be allowed to increase spending beyond \$9,000. These school systems would thus be entirely funded by the state, except that local school systems would be allowed to use property taxes to pay off current bonds. School systems that currently spend more than \$9,000 would be allowed to use existing local revenue sources, including the property tax, to continue to fund education at the current per student level.

For FY 2008, QBE earning per student is projected to be \$4,437. Increasing this to \$9,000 per student would slightly more than double state spending on education, from \$7.134 billion to \$14.470 billion, an increase of \$7.336 billion. Under this option, and assuming state funding per student of \$9,000, property taxes would have fallen by an estimated \$5.341 billion in FY 2006. The reduction in property taxes would be less than the increase in state spending since those systems that currently spend less than \$9,000 would experience an increase in spending per student.

School systems that currently spend more than \$9,000 per student would be allowed to increase per student spending by no more than a set percentage. If the increase in state funding of education exceeded this allowable growth rate, then the local school system would have to reduce its tax revenue to match the allowable local spending.

For example, suppose that the maximum allowable growth in spending per student was half a percentage point more than the rate of inflation, and inflation was 3.5 percent. Thus, the maximum increase would be 4 percent. Consider a local school system that was spending \$11,000 per student and an increase in state funding per student from \$9,000 to \$9,500. The local system would be allowed to increase spending by \$440 (4 percent of \$11,000). Since the local school system would be receiving \$500 in additional revenue per student from the state, the local school system would have to reduce local taxes by \$60 times the number of students. The system would spend \$11,440 per student, of which \$9,500 would come from the state and \$1,940 from the property tax.

Option 2. A Matching Grant Program

Under this option the state would require that all local governments reduce their property taxes by some percent, but by less than 100 percent. For example, local government could be required to reduce property taxes by 50 percent or 90 percent. For 2006, a 50 percent cut in property taxes would have amounted to a cut of an estimated \$5.386 billion.

The state would then implement a grant program under which the state would match each local government's property tax revenue. If the mandated reduction in property taxes was 50 percent, the matching rate would be one, i.e., the state would give one dollar in grant funds for each dollar of property tax revenue. Thus, if a local government had been collecting property taxes of \$25 million, it would have to cut property taxes to \$12.5 million. The state would then provide a grant of \$12.5 million. Thus, the local government would be kept whole.

The concern with the proposal is that since the state will match local property taxes, local governments will have an incentive to increase property taxes. Without a matching grant program, every additional dollar the local government spend on, say, police, costs the local taxpayers one dollar. With the matching grant in the example, such an increase in spending would only cost local taxpayers 50 cents. This increase in expenditures would result in additional property taxes that would have to be matched.

Thus, in the example above, the local government might increase property taxes from \$12.5 million to, say \$16.0 million, or by \$3.5

million. Thus, the state would have to fund a grant of \$16.0 million while property taxes went down a total of \$8.5 million (the initial \$12.5 million less the increase of \$3.5 million). The greater the matching rate, the greater the incentive local governments have to increase property taxes.

To eliminate this incentive the State could impose a limit on the increase in property taxes that would be eligible for a matching grant. For example, increases could be restricted to the rate of inflation plus population growth plus 0.25 percentage points. If property taxes increased by more than that, the additional property tax revenue would not be matched. Thus, the cost to the local taxpayers of a one dollar increase in expenditures would be one dollar.

One likely concern that local government would have is that the State might not fully fund the grant program. For example, in some year the State might provide only a 40 percent match. If this happened, local governments would be allowed to increase property taxes to compensate for the State's under funding of the grant program.

Option 3. Rebate to Property Owners

A variation of the Option 2 is for the State to rebate a certain percentage of the property taxes paid by the property owner directly to the property owner. For example, the state could rebate 50 percent of an individual's or firm's property tax liability.

One advantage of this option over the matching grant option is that this option does not put the local government at risk if the state does not fully fund the matching grant program. In addition, the state can set up the rebate program so that the rebate rate is determined by the amount of property tax relief the General Assembly wants to fund. Furthermore, since the State is sending a check to the taxpayers, the State would be recognized as providing the property tax relief.

This option has the same incentive effect on the level of property taxes as does the matching grant program. If residents understand that if the local property taxes increase the state will pay some percentage of that increase, then residents will be less resistant to property tax increases.

Limiting the increase in property taxes subject to the rebate is an easy way of addressing this increase under the matching grant program. For the rebate program, it would be harder to implement such a provision. It is not possible to restrict the increase in property taxes that are rebated to a specific property owner since owners change and property values change due to expansions.

One way to address the incentive issue would be the following. For every jurisdiction the increase in total property taxes that exceeded the allowable increase in property taxes would be calculated. The percent of total property taxes that would be subject to a rebate would then be calculated. Every property tax bill would then include the amount of property tax that should be rebated. The owner would then send in the property tax bill, alone with a receipt indicating that the property tax had been paid, to the State, which would then write the check.

Certainly this option is more cumbersome and would have substantially larger administrative costs. It would also be a target for fraud.

The rebate program could be designed to target the property tax relief. The rebate percent could vary by the type of property. Furthermore, the rebate to residential property tax owners could be limited to the amount by which a household's property tax payment exceeds some percentage of the household's income. Furthermore, the rebate on rental property such as apartments could be provided to the renter, rather than the owner.

Option 4. Revenue Sharing Grants and Tax Rate Flexibility

HR 900 would fund local governments by providing local governments with a share of State revenue. As noted above, there are serious problems with the specific sharing arrangement called for in HR 900. No specific proposal for funding local governments has yet been advanced as part of the GREAT Plan. Option 4 is a significant modification of the proposal to fund local governments contained in HR 900.

One of the implicit objectives of HR 900 is to hold each local government harmless, i.e., to replace the lost property tax revenue, and to keep the total cost to the State to exactly the total property tax revenue eliminated. Options 2 and 3 do that. However, designing a grant program that would accomplish those twin objectives, while eliminating all property taxes, seems impossible. For example, a grant program that provided substantially difference grants per student across local school systems would likely be ruled a violation of the equal protection clause of the Georgia Constitution. In addition, the grant program has to allow for differential changes in population. Even if one could design a grant program to accomplish these two objectives, local governments would still lose its fiscal discretion over the level of spending.

Option 4 proposes a grant program that would replace all property taxes, but would not necessarily hold all governments harmless. In addition, local governments would be given control over other taxes.

The grant program would be funded as a specified share of total State revenue or a specified share of the total of certain revenue sources. For example, according to the Census, in 2005, local property taxes were about 39 percent of the total revenue of the State sales tax, the personal income tax and local property taxes.

Given the differences in the functions of counties, municipalities and school systems, different grant formulas would have to be designed for each. For local school systems, the easiest and probably most appropriate approach would be to make the funds part of the QBE funding.

For other local governments, grants would be based on a formula that was driven largely by population. Other factors that could be included are population density and percent poverty. The objective would be to get a formula such that the grant revenue allocated to a specific government was close to the property tax revenue that that government currently collects. It would take a lot of work to determine what such a formula would look like. Furthermore, separate grant programs would have to be designed for municipalities and counties. There are also special districts that rely on property taxes; these would require yet another grant program. The funds would be provided with no restriction as to how they could be used.

In addition to the grant funds, local government, including local school systems, would be allowed to vary the local sales tax rate. Such options are available to local governments in other states. This would increase the administrative and compliance costs of the sales tax. In addition, local governments could be given authority to levy other taxes. For example, a payroll tax could be established, which is an option available in several states. Separate rates would be established by each local government, with the individual paying the total of the rates. The revenue could be shared between where the individual lives and works.

Summary

This policy brief has outline four options for funding local governments if the State substantially reduces or eliminates property taxes. Much work would have to be done to determine the specifics of any one of these proposals.

Notes

1. Sjoquist (2007a) provides a summary of HR 900.
2. Sjoquist (2007b) discusses the many issues and questions that arise in funding local governments if property taxes are eliminated or substantially reduced.

References

Sjoquist, David L. (2007a). "A Description of the Proposed Comprehensive Revision of Georgia's Tax Structure: HR 900." FRC Brief #151, Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University.

Sjoquist, David L. (2007b). "Issues Associated with Replacing the Property Tax with State Grants." FRC Brief #157, Fiscal Research Center, Andrew Young School of Policy Studies, Georgia State University.

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