Virginia's
Rural Economic Analysis Program

REAP Policy Paper No. 11

Taxation: No Simple Answers

Wayne Purcell and Jeffrey Alwang

People do not like to talk about taxes, especially as April 15 approaches. But taxes are being discussed more often in meetings involving town, county, and city administrators; elected county and city officials; Commissions in the Commonwealth of Virginia; and members of the Virginia legislative and executive branches. The taxes used to raise local revenues to pay for education, police and fire protection, libraries and other services may be headed for change. Issues of equity and fairness, efficiency, and control all need to be factored into decisions regarding tax structure.

> "Virginia's existing tax structure is causing serious economic challenges to our local governments." *Hampton Roads Review*, p. 1.

One of the reasons for the increased interest in the topic of taxation is that the most important source of local funds, by a considerable margin, is the real property tax. As the economy changes, the appropriateness of this tax is being questioned. The property tax has been used as a means of financing local governments since early settlers first arrived. Historically, the real property tax was justified on a number of counts: it was easy to collect; it did not distort incentives for improvements to property; and a close correspondence existed between land holding and wealth.

Today, concerns emerge as other taxes, equally easy to collect, are available and the relationship between land ownership and wealth becomes less clear. The real property tax is still favored by many since land is an immobile resource, and the tax provides a stable source of revenue for local governments. Others argue that it is a regressive, archaic means of raising revenues and that reliance on the property tax represents a major constraint to Virginia's local governments. The purpose of this article is to describe a number of concepts that are essential for understanding the debate about taxation.

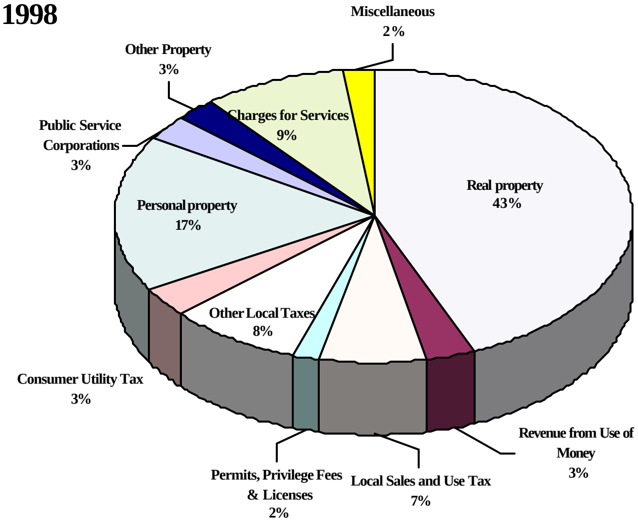
Localities spend most of their revenues—often 70.0 to 80.0 percent—on education. Increased emphasis is being placed on educational quality; more attention is focused on accountability of local public schools; and new standards of learning are being implemented. Often these pressures dictate increased funding for schools. Because the property tax is the primary tax over which localities in Virginia have control, increases in the property tax rate are usually proposed. Elected local officials, professional administrators, educators, local planners, and the taxpaying public are all concerned about how education and other local services will be financed.

In fiscal year 1998, 65.0 percent of the total revenue available to localities in Virginia were generated locally: real property taxes, personal property taxes, licenses, fees, sales taxes, and other minor sources (Figure 1). Virginia localities received only 6.0 percent of their total revenue from the federal government, either as federal pass through or direct federal aid (Figure 2). With such a large percentage of revenue being raised locally, local governments are, understandably, increasingly concerned as to how they will cover their ever greater commitments.

Wayne Purcell is Alumni Distinguished Professor and Jeffrey Alwang is Associate Professor, Department of Agricultural and Applied Economics, Virginia Tech

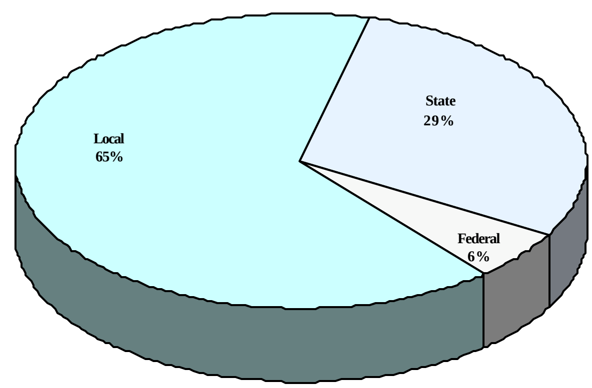
REAP is the Rural Economic Analysis Program in the Department of Agricultural and Applied Economics, College of Agriculture and Life Sciences at Virginia Tech

Figure 1. Sources of local revenues, year ending June 30, 1998



Source: Auditor of Public Accounts

Figure 2. Sources of revenue for local jurisdictions in Virginia, year ending June 30, 1998



Source: Auditor of Public Accounts

Some dimensions of the tax question would benefit from more research, and certainly most dimensions would benefit from increased discussion. Documenting those discussions is useful as further considerations of tax strategies are evaluated in the Commonwealth. An on-going study commission (Commission to Study Virginia's State and Local Tax Structure for the 21st Century) is looking at the tax issues in Virginia with the intent of establishing a base for appropriate tax strategies in the years ahead. That commission has already conducted public meetings in several areas of the state. Some of the same issues have reportedly come up at all the meetings.

Fair and Equitable Taxes

Discussions about taxation almost always begin with a stated intent that the tax system be fair and equitable. However, a great deal of confusion surrounds the meaning of these terms. Clearly, what is fair in terms of taxing is, to an extent, in the eyes of the beholder. Some participants in the discussion of fair taxes adhere to the notion of an equal tax rate for everyone. A flat tax on income at 10.0 percent, for example, is arguably a fair tax because everyone pays 10.0 percent. This argument extends to a sales tax which is the same for all buyers. Advocates of this type of fairness are generally looking for strictly defined equal treatment for all taxpayers. The effect of an equal tax can be seen with the sales and excise taxes in Table 1. As family income rises, the percent of sales and excise tax paid as a percentage of total income decreases.

Opponents of a tax that applies equally to everyone allege that it is anything but fair, that it is, in fact, regressive. High-income families paying 10.0 percent of their incomes in taxes have much larger disposable incomes for consumption, investments, savings, and preparing for retirement, than low-income households. While the household with $100,000 income may spend more total dollars on food, clothing, and shelter than the household with $20,000 income, the proportion of total income allocated to these necessities is different. Lower income households pay proportionally more of their incomes on necessities, leaving far less available as discretionary income. This perspective leads to the argument that some sort of progressive or graduated tax is more nearly fair and equitable.

Table 1. Percent of family income paid in taxes by non-elderly, married couples, 1995

	Income Group				
			Top 20%		
	Lowest 20%	Middle 20%	Next 15%	Next 4%	Top 1%
Type of taxes paid	--------------------	--------------------	%	--------------------	--------------------
Sales and Excise	5.2	3.2	1.8	1.3	0.8
Real Property	2.8	2.1	2.4	2.3	1.7
Income	1.7	3.4	4.1	4.3	4.7
Federal Deduction for State Tax Payment	0.0	0.4	1.6	1.9	2.1

Source: Michael P. Ettlinger, Robert S. McIntyre, Elizabeth A. Fray, John F. O'Hare, Julie King, Neil Miransky, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*. Citizens for Tax Justice and The Institute on Taxation & Economic Policy. June, 1996. Found at *www.ctj.org*. Accessed March 15, 2000.

A progressive income tax would show tax rates going up as incomes go up. Virginia has a graduated or progressive income tax schedule, but the levels of taxation go up by only small increments as household income moves from $25,000 to $50,000 to $100,000 and up. Nonetheless, advocates of any tax that taxes higher income households at a higher rate would consider this type of tax policy to be more nearly fair and equitable.

> Local government pays for the services it provides through the taxes it collects. If the governing body reduces taxes, the likelihood of the number of services being decreased or the quality of services being reduced is high. Over the past decades, local governments, by relying on market mechanisms, reduced costs of providing services. Today, no more efficiencies can be gained, and tax reductions will translate directly into reduced services.

Supporters of flat taxes argue that a flat tax can be structured to be very progressive. If a flat rate income tax excluded the first $25,000 or $50,000 in income, for example, it could be considered progressive. Those more able to pay would, in fact, be paying proportionally more, while those with low discretionary incomes would pay nothing or proportionally less. A sales tax that excludes certain foods and clothing categories, so that luxury items rather than necessities are taxed, would also be considered progressive, or at best, would be seen as less regressive than one which taxes all food and clothing.

> *Fairness*: marked by impartiality, free from self-interest, prejudice, or favoritism; achieving a proper balance for all sides.
> *Equitable*: in taxation, a tax where the poor pay much less proportionally than do the rich. *Progressive* taxes more nearly match the tax burden to the ability to pay. *Regressive* taxes impact lower income individuals relatively more than higher income individuals.

Equity also extends to the distribution of the tax burden and revenues across space. Poorer jurisdictions have low capacity to raise tax revenues because income, wealth, and property values are low. Yet, these same localities should, and in many cases are required to, provide minimum levels of service to their residents. Thus, state-collected taxes are often distributed to meet equity objectives. Discussion about equity are often lost when addressing tax policy, but one of the fundamental roles of government is to ensure that all citizens have equal access to basic public services.

Taxing a Stock Wealth or a Flow of Income

The discussion of whether a stock of wealth or an income flow should be taxed is an old one. The idea of taxing wealth is widely accepted as wealth can usually be easily converted into income. Those holding wealth are likely to be producing a flow of income from that stock of wealth. People who are not using such wealth to generate income may be holding their wealth in less than optimal investments. The real property tax is based on a stock of wealth, not on a flow of income. The wealth from the land holding could be readily converted to income if it were invested in a more economically efficient manner. Some argue against the real property tax by saying that it is difficult to pay taxes on wealth that generates little income. The real question, however, is whether that property will generate income over the lifetime of its holding. If it does not, such investments represent fundamentally misallocated resources and ought not to be encouraged by public policy. If it generates income over the life of the investment, borrowing against this flow of income is a possible means of paying taxes.

Situations where considerable wealth has been accumulated in real property that produces little or no income flow are easy to find. Such situations occur as business operations sweep through national business cycles or suffer through economic recessions. They occur for farmers who face a global marketplace with commodity selling prices well below costs of production. A farmer may not see net incomes adequate to pay even use-value taxes generated from a land base that could be worth a million dollars or more for development purposes. These farmers need innovative means of converting their wealth into an income flow of sufficient strength to pay their tax liabilities.

The owner of a valuable piece of business property on a corner lot in a town or city or a farmer with 500 acres worth $10,000 per acre for development can hardly be considered poor. Little or no cash flow may be associated with land-based wealth. Land is an investment and returns on that investment ought to be taxed as are returns on other investments such as stock dividends. Being land poor (owning land that earns no flow of income but is valuable for some kind of development) can become difficult for the taxpayer. For example, a couple lives in a house that has appreciated significantly over time. When they retire, they may be forced to sell and move to some other area or to some other state because their retirement income is not sufficient to pay taxes on the house and related real property. Clearly, people who desire not to move ought to use estate and retirement planning to protect themselves against future tax liabilities. Reverse mortgages, for example, might be one way of managing future tax liabilities and maintaining an acceptable quality of life for people in retirement.

If incomes were taxed at the local level, the burden of raising money to finance local services would be redistributed, at least partly, from the land to the salaried employee or wage earner. A local add-on income tax of 1.0 percent, for example, has been proposed in legislative initiatives in Virginia. The idea is that the add-on income tax revenues would be allowed to replace dollar-for-dollar revenues from real property taxes. Achieving a statewide uniform tax rate without some mechanism for sharing this revenue across localities may be impossible because incomes, land values, and land tax rates vary significantly across the Commonwealth.

> "Efficiency as it refers to taxation is concerned with the effect of taxes on consumption decisions and the allocation of resources. An efficient tax corrects market failures by compensating for externalities [and unintended impacts]. Equally acceptable under the efficiency criterion is neutrality. A tax is neutral if it does not distort consumer or business choice. A tax that alters prices in a way that causes a change of consumption choice . . . [will generally be seen as] an inefficient tax. [The inefficiency comes in the form of a] loss of satisfaction due to the consumption of a less preferred commodity."
>
> Neil Gilchrist. "Land Value Taxation." *http://www.taxreform.com.au/lvt.htm* accessed 3/16/2000

Most opponents of a progressive income tax argue that taxing at a higher rate the last dollar of income earned by prosperous firms or wealthy people decreases their incentive to create the very business activity important to a strong and robust economy. While the literature does not pinpoint at exactly what level a governing body needs to worry about the impact of an incrementally increasing tax, it is, in fact, an issue that needs to be kept in mind when discussing alternative tax strategies.

Efficiency in Taxation

Efficiency in taxation is related to how the tax affects incentives faced by people in the economy. Efficient taxes create no disincentives for profitable economic activities. When taxes are used directly to pay for services, efficiency is achieved by having the people who benefit from services and the people who create the costs pay taxes to support those services. The efficiency of a particular method of taxation also relates to cost of collection: efficient taxes are inexpensive to collect compared to the revenue they generate. The real property tax is usually considered to be efficient, especially when the rate on unimproved land is significantly higher than the rate on improvements to the land. It is efficient mainly because land does not move, and it is easy to estimate the value of unimproved land.

Examples of inefficient taxes include different governing bodies taxing a different set of goods and services or taxing the same set of goods and services at different rates. These types of taxes lead to tax avoidance on the part of the taxpayer. For example, if localities were afforded the right to levy an add-on local income tax, administratively, this tax can be handled fairly easily and calculated as a percent of the state income tax the taxpayer will pay. No substantial new infrastructure or mechanism is required to levy and collect the tax. But if one county were to decide to have a 0.5 percent local income tax and a neighboring county, with budget problems, decided to have a 3.0 percent local income tax, some spillovers would easily develop. Other things being equal, people would tend to move from the higher taxed county to the lower taxed county. This redistribution of people, because of the differences in the tax programs and services provided for those taxes, has ramifications for the value of land and houses, for the support for local services like education, and even for highways and roads as patterns of road use change.

Inefficient taxes can also distort (alter) market behavior. If a tax were imposed on soft drinks but not on milk, people might switch from soft drinks to milk to avoid the tax. The distortions can extend to the housing market, to real estate, and to many other dimensions with substantial differences between different governing bodies.

Inefficient taxes sometimes can be passed to individuals who do not use the service in question. For example, many states rely on gasoline taxes to pay for highway construction and maintenance. These taxes tend to be efficient because the user of the service (the road) pays for its upkeep. Other states use general revenues to fund much of their road needs. Such a pattern of taxation is inefficient because the general taxpayer may not be an intensive user of the road. Also, the tax has been passed from out-of-state users (who buy gasoline as they use the roads) to in-state nonusers, such as urban residents who rely on public transportation but pay taxes into the general fund. Because users are not paying for the service, inefficient overuse will occur.

The possibility of distortions in incentives and in the marketplace has to be kept in mind whenever taxation is being discussed. Efficient collection is, arguably, one of the reasons for the continued significant reliance on property taxes. Local governing bodies have significant flexibility to raise the tax rate on local real property for financing school building programs, a new fire station, and other local services. The asset that is being taxed cannot move to the neighboring county or state. While it may not be popular for those who are paying the taxes and own the property, the flexibility in rates is, nonetheless, an important consideration for local public financing.

Real property taxes around the state show huge differences from county to county: from \$0.31 per \$100 assessed value to \$1.44 per \$100 assessed value (Figure 3). These differences are clearly a manifestation of the argument that real property taxes can and will be seen as a flexible tax instrument that governing bodies can use to finance local services.

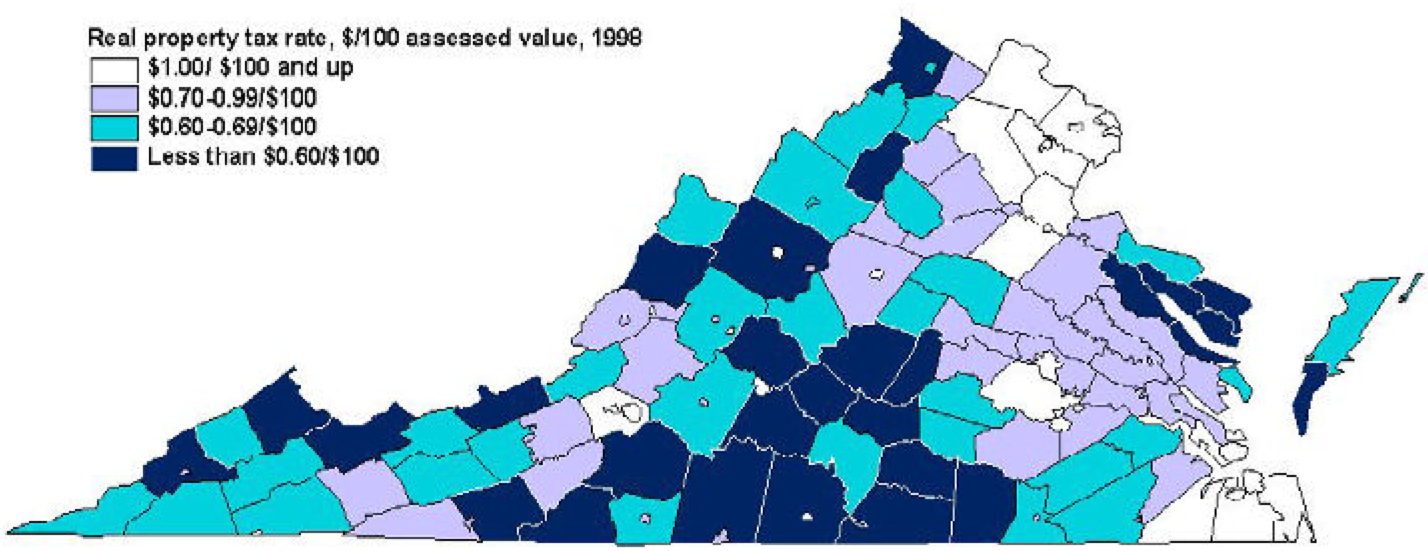
The advantages of property taxes should be kept firmly in mind when debating different tax options.

Figure 3. Real property tax rate, 1998

Taxing Authority: State versus Local Control

Taxation cannot be debated without considering who controls the power to tax, who controls revenue from different taxes, and who is responsible for delivering services. Virginia is a Dillon's Rule state:[1] localities can only use those powers expressly given to them by the state. The state granted localities the right to use the real property tax. In Virginia, the personal property tax had also been an important source of local revenue. Food taxes on meals served in restaurants and hotel and motel taxes on room service for those traveling through the counties are also examples of taxes that the state has granted local governing authorities the right to use. Business licenses and various other license fees and excise taxes are also part of the mix. To date, however, the local governing authority does not have the right to increase the local sales tax without seeking explicit legislative permission, nor does it have the right to add a local income tax without seeking explicit legislative permission.

Supporters of Dillon's Rule argue that this authority needs to be kept at the state level. Distortion and other problems occur when activities are taxed at different rates in different localities. If the state does, in the future, allow local governing bodies to use local sales tax or local income tax or both as alternatives to those taxes they are now permitted to employ, a provision is likely that any such tax must be applied at consistent levels statewide. For example, in the future, legislative action might allow local governing bodies to employ a 1.0 percent local income tax. Keeping the rate the same would avoid the distortions that would occur if counties and



Source: Knapp

[1] For more complete discussion of the ramifications of Dillon's Rule, see Richardson, Jesse. "Variation on 'Mother May I?' Dillon's Rule," *Horizons*. Volume 10, Number 6. November/December 1998. Can be found at *www.reap.vt.edu/reap*, publications, Horizons

cities taxed at different rates. However, because of variations in local real property tax bases, revenues generated by localities currently differ substantially by jurisdiction. Many localities find it difficult to raise tax revenues because of a weak property tax base. These same localities often suffer from low incomes and might not benefit at all from a switch to an income tax, unless taxes from wealthier jurisdictions are passed on to poorer ones. Just as the state income tax is not shared equally across jurisdictions, equity may require sharing such local income tax options across jurisdictions. An objective formula for such sharing would have to be used.

Obviously, the same arguments apply to local sales taxes. A city would find a 5.0 percent local sales tax counterproductive when the surrounding county, with growing shopping centers, has no local sales tax or a very modest one, such as 0.5 percent. The result would be that businesses selling products subject to sales tax would move out of the city and into the county. Consumers would abandon downtown city merchants.

Alternative Taxes

Alternative tax solutions might be needed in addition to considering the possibilities of using local sales or local income tax to either supplement real property taxes or replace part of the tax burden on real property. Seeing the tax emphasis shift away from a real property tax would not be surprising if the state allows local jurisdictions to use other means of taxation. In a modern, sophisticated, high-tech employment economy, income flows will increasingly be associated with services and the value of information. The income flows and ability to pay taxes may be less closely correlated to land wealth in future years.

Other alternatives might be impact fees, which the real estate industry and building contractors allege will increase housing costs but may rather result, over time, in decreased margins for these industries. Some localities use service districts to tax those who use specific services like mosquito control. Other alternatives, based on the goals of the locality, need to be explored. Knee-jerk reactions to any discussions of tax structure do not contribute to solving the problem.

Overall Thoughts

Taxation is a complex area with no simple answers. As taxation strategies are discussed, therefore, a thoughtful debate on state versus local control, fairness and equity, and the wisdom of taxing stocks versus income flows needs to take place. Perhaps some things that are more nearly public goods, such as education, ought to be financed at the state level. State control of education might be more efficient, equitable, and fair than differing levels of support at the local level. But these issues will need to be addressed as the discussion about whether local municipalities or the state should have authority to levy certain taxes continues. Like all the considerations dealing with increasingly active areas of discussion, there are no simple answers.

References

Auditor of Public Accounts. Comparative Report of Local Government Revenues and Expenditures, Year Ended June 30, 1998.

Gilchrist, Neil. "Land Value Taxation." *http://www.taxreform.com.au/lvt.htm* accessed 3/16/2000

Hampton Roads Planning Commission. "Fiscal Stress: Local Governments Facing Future Financial Crisis," *Hampton Roads Review*. January, February, March 2000, p.1.

Knapp, John. *1999 Tax Rates: Virginia's Cities, Counties, and Selected Towns. http://www.virginia.edu/coopercenter/ vastat/ taxrates1999/taxratesfiles.html* accessed March 28, 2000.

.

Virginia Cooperative Extension

2000 Publication 448-311/REAP P011

April 2000

VT/001/0400/3.9M/20203628