Fiscal Research Center

policybrief

July 2007, Number 157

ISSUES ASSOCIATED WITH REPLACING THE PROPERTY TAX WITH STATE GRANTS

Proposals have been advanced that call for the elimination of all property taxes in Georgia, with the resulting loss in local government revenue to be replaced through a state grant program. HR 900, introduced at the end of the 2007 session of the Georgia General Assembly by Speaker Glenn Richardson and others, calls for a grant program in which each local government would get a share of state tax revenue, where a government's share would equal that government's 2006 revenue divided by the 2006 revenue collected by all governments in the state, including the state government. A new alternative proposal from Speaker Richardson has been made public. However, unlike HR 900, which calls for the elimination of nearly all taxes, the new proposal, referred to as The GREAT Plan for Georgia, would only eliminate property taxes.[1] Presumably, under the GREAT Plan, local governments would receive revenue from the state to replace the lost property tax revenue, but as of this time there are no details of how the grant program will be structured.[2]

If either of these proposals is implemented, it would be a major change in how local governments are financed, would reflect a significant shift to the state of the responsibility for funding local governments, and would result in a major reduction or elimination of the fiscal discretion of local governments. This policy brief presents a set of issues and questions that should be considered as the state considers the elimination of local property taxes and their replacement with state grants. We assume that only the property tax will be eliminated and that local government will continue to rely on local sales taxes and other sources of revenue.

This brief focuses on the issues that arise in reducing local government fiscal discretion and establishing a state grant program to replace the lost revenue. The brief does not address the effects of replacing property taxes with other revenue sources on such things as the level of economic development, the prices of land and housing, tax equity, the composition of business, etc. This brief is one of several policy briefs and reports that the Fiscal Research Center will prepare that address various aspects of these two tax reform proposals.

- The intent of HR 900 is for the state to replace the lost property tax revenue for each local government, essentially holding each local government harmless. But this would mean that local governments that had imposed higher property taxes would get more revenue from the state. Thus, the Decatur City school system would get a grant of about $8,671 per student while the Pelham City school system would get a grant of about $565 per student, over and above the current QBE funding.[3] Wide variations in the level of property taxes also exist across other local governments — counties, municipalities and special districts. Would a grant system in which the state allocated disparate amounts per student or per capita hold up to a court challenge?

- If a given year, for example 2006, is used as the basis for holding local government harmless, then local governments that were created after 2006 would receive no grant revenue. How would this situation be handled?
- If local governments are held harmless in the initial year, how does the grant system account for changes in the jurisdiction over time that could result in the need for additional or less revenue? Local government could experience changes in the size and composition of its population or in the geographic area it serves. The number and mix of its businesses could change. State or federal government mandates could be added or removed. The local government might experience a change in the revenue that can be or is generated from other sources.
- If the state holds local government harmless based on property taxes collected in some year, would adjustments be made if property taxes in a particular jurisdiction were unusually high or low that year? For example, a jurisdiction may have had an unusual expense or emergency that year and increased property taxes to cover it, or perhaps some non-property tax revenue source produced larger than normal revenues and as a result the local government reduced its property taxes that year.
- If the sales tax base is expanded as proposed under the GREAT Plan, the revenue from local sales taxes will increase. Should that be factored in when considering what it means to hold local governments harmless?
- There are numerous types of local governments that rely on property taxes to fund public services, including school systems, counties, municipalities, community improvement districts, and special service districts. Would all of these governments be included in the grant program?
- Are there any issues that arise from the existence of enterprise zones or tax abatement programs?
- If SR 20 is also approved, will the state be able to increase its revenue in order to fund local governments? SR 20 would restrict the annual growth in state tax revenue to the increase in population and inflation and as currently written would seem to go into affect before the General Assembly could increase revenues to fund local governments.
- What are the implications for debt of eliminating the property tax?[4] Would eliminating the ability of local governments to use the property tax violate existing legal covenants of General Obligation bonds? What would happen to the perceived risk and thus to the interest rate that would have to be paid on new bonds? Several jurisdictions have established TADs and issued bonds backed by the increase in property taxes from the expected development. How will these be handled if the property tax is eliminated?
- What provisions would need to be put in place to handle emergencies that require a large one-time expenditure?
- How would infrastructure or capital improvements be financed under this system? Infrastructure expenditures, particularly in smaller jurisdictions, are lumpy and are frequently financed through debt.
- If a grant system such as that specified in HR 900 is not adopted, the major question becomes, what will the grant system look like? There are numerous issues and questions that arise in addressing this question.
    - Can the same grant system be used for all local governments? Municipal governments have different responsibilities than county governments, and both differ from school systems. Counties differ in their responsibilities to the extent that the sizes of the population in the unincorporated areas differ.
    - Should the grant allocation be based on a formula or should the allocations be made on an ad hoc, subjective basis? Under a formula-based system the size of a jurisdiction's grant will depend on certain specified measurable factors and the grant amount would be known to the local government. An ad hoc, or subjective system, would essentially budget funds for each government as if it were a department of state government.
    - If an ad hoc funding system is adopted how will the state manage budgeting for nearly 900 local governments?
    - Would differences across jurisdictions in input costs be accounted for? There are differences across jurisdictions in the wage rates that have to be paid and large differences in the price of land, which is important for parks, fire stations, roads, etc.
    - How much discretion will local government have over how the grant funds are spent? Currently, the largest state grant program for local government is the funding for education, i.e., QBE. The state has imposed substantial restrictions on how these funds can be used.
    - Will the grants be categorical or general revenue grants? The state could have a separate categorical grant programs for each local government function, e.g, for parks, for police, for courts, for fire, for trash collection, etc. Or, the state could provide general revenue funds that the local government would allocate across services at its discretion.
    - Will only certain services be funded? For example, some local governments finance trash collection through taxes while others use fees and still others require citizens to arrange for it themselves. How would a state grant system handle these differences?
    - Differences in expenditures are the result of differences in need and in differences in demand or preferences. How would a grant system account of these differences? Citizens differ in the level of public services they want, as reflected in differences across jurisdictions in expenditures per capita, and in the composition of services, as reflected in differences in the allocation of the budget across functions or services. There are also differences in need

across jurisdictions. Consider fire services. There are numerous factors that determine the expenditures on fire services and that result in different levels of expenditures across communities. Among the factors that are associated with differences in expenditures for fire services are: the presence of a passenger airport; the number of tall buildings that require special trucks and equipment; the extent to which traffic congestion affects response time and thus the number of stations needed; differences in the likelihood of a fire due to the types of businesses and the age and conditions of buildings; population density; and the probability of bomb threats. Expenditures also differ because of differences in the quality of fire services demanded, as reflected in fire service ratings.

  - Under the GREAT Plan, local government will retain their local sales taxes. Would the grant system make adjustments for differences in the magnitude of these revenues, either actual collections or potential collections in the case of jurisdictions that do not levy both a LOST and a SPLOST?

- Would the two counties that have a HOST be able to convert them to LOST or SPLOST without a referendum?
- Can and should assurances be put in place that funding of local governments would not be the first thing cut out of the budget if state revenue growth slows?
- Will the elimination of the property tax increase the volatility of tax revenue?
- The property tax will generate an estimated $10-$11 billion in 2008. If the state increases its spending accordingly, what implications are there for the revenue reserve fund? Should the percentage of the budget set aside for the Revenue Shortfall Reserve be increased?
- Are there any implications for the state's bond rating from the change in the state tax structure?
- The property tax could be eliminated and local governments given authority to generate revenue from other taxes and revenue sources. For example, local governments could be allowed to vary the sales tax rate, to levy a payroll tax, to impose an add-on to the state fuel tax, to impose fees on a neighborhood for providing certain services such as street lights, etc. Would allowing this mix of revenue sources be better or worse than having the state assume the major responsibility for funding local governments?

The questions and issues listed above focus largely on the design of a grant program and the direct implications of replacing local property taxes with state grants. The following is a list of possible changes in local government behavior that might result from the replacement of local property taxes by state funds.

- Without the ability to raise the property tax rate to finance increases in expenditures, some local governments are likely to turn to local revenue sources such as fees, licenses, occupation taxes, etc. Local governments, particularly those that have very limited legal authority to collect non-property tax revenue, are likely to request permission to levy a host of new taxes or to vary the local sales tax rate.
- Eliminating the property tax will reduce the incentive for local government to attract business. Without a property tax, local governments would have no need to attract businesses in order to increase the property tax base. If local governments were reliant on sales taxes, there will likely be increased competition for retail establishments, especially for shopping centers. Since most businesses would not generate much revenue but would generate expenses, will communities will be less anxious to attract businesses? Local governments will still have an incentive to attract businesses in order to create jobs.
- With less fiscal discretion, local government may be less able to provide incentives to attract and grow businesses.
- If the grant funds from the state are based on 2006 revenue, as proposed in HR 900, municipal government would be less inclined to annex land since it would bring additional expenditures but no additional grant revenue.
- Since increased public services will not require an increase in property taxes, will citizens demand more revenue from the state to finance more services? The property tax serves as a local "price" for public services, so that local residents currently pay for increased expenditures. Thus, the property tax acts as a constraining factor on local tax and spending. But with state funding of local services, local residents will pay only a small fraction of any increase in expenditures in their community. Will this encourage local officials to increase their lobbying for additional revenues? Would the result be similar to what some observe about federal funding, where people may see federal money as essentially "free money" since a community pays such as small fraction of the cost of a new service?

Notes

1. From a discussion of the provisions of HR 900, see Sjoquist (2007). The GREAT Plan can be found at www.TheGreatPlanfor Georgia.com.

2. A proposal was advanced in 2003 to eliminate all property taxes for school purposes. For a discussion of the issues associated with that proposal see Sjoquist, Matthews, and Smith (2004).

3. These are local revenue per student as reported by the Georgia Department of Education and may include some non-property tax revenue.

4. The presentation on the GREAT Plan states that property taxes for current bonded debt would not be eliminated.

References

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

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Issues Associated with Replacing the Property Tax with State Grants - Brief

Publisher(s): Fiscal Research Center of the Andrew Young School of Policy Studies

Author(s): David L. Sjoquist

Date Published: 2007-07-01

Subject(s): Community and Economic Development; Government Reform