

School Finance Reform:
Moving from the School Property Tax to the Income Tax

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1 Introduction

Public resistance to local property tax increases to finance local government has been widespread for a considerable period of time. Indeed, phrases like “Prop 13” or “Prop 2 and 1/2” are short-hands for taxpayer anger over their property taxes, and the demonstration of their anger at the polls with the subsequent imposition of limitations on how much local property taxes may grow. Academic interest in the effects of such limitations has followed these political acts, and there is an active public finance sub-literature that seeks through the application of various statistical modeling techniques to ascertain the effects on the level and distribution of local public services. A major strand of the school finance literature has examined the distributional implications of relying on the local property tax in conjunction with various state school aid formulas to judge whether the net effect of local and state fiscal decision-making results in adequate educational resources. Litigation on states’ failure, due to reliance on the local property tax, to provide for “thorough and efficient” k-12 education has persisted since the 1960’s, and better than 20 states face plaintiffs who seek more state resources directed to poor districts (defined as low assessed value/student) as an appropriate financial remedy.

My purpose here is twofold: (i) to extend another strand of the public finance debate over state and local school finance by deducing from first principles how public education *should* be financed, and (ii) examine, albeit briefly, some neglected aspects of the political economy of the local school property tax which may well explain why property taxpayers are so upset.

By way of summary, I find the local property tax wholly inappropriate as the local source of finance for public education, and instead find an income tax, imposed at the local level at a fixed rate, to be conceptually superior to the property tax, especially when coupled with a state foundation aid formula which makes up for any local income tax-base inadequacies. State aid should in turn be financed by a broad-based income or sales tax as well. As a positive, empirical proposition, the growing *relative* burden of the local residential property tax explains why it has become so unpopular. The growing relative burden of the residential property tax originates with powerful forces emanating from the tax committees of the Congress, and explains why in the 1980’s several states classify their local property tax to forestall the federally tax-induced shift in burden *from* commercial and industrial property *to* the residential and rural property tax.

2 Efficiency and Distributional Arguments for Financing Public Education with Income Taxes

2.1 Efficiency and Equity Concerns

Public support of k-12 education has been traditionally argued in the U.S. as the single most important way that children of any socioeconomic background can further themselves, and through their subsequent efforts in the world of work, further economic growth.

Not only are there likely to be economic benefits which will accrue to children of various backgrounds which can not be readily predicted by their parents, society, or private capital markets, but, as Weisbrod (1964) argued, education generates externalities through a better educated public which improves the overall quality of life for all.

Public education thus functions as a form of insurance to ensure that the private sector will be as productive as possible, and also as a way to create future public benefits for society. We obligate ourselves through state and local taxation to support the costs of public education for these efficiency and public goods purposes. Moreover, public education is viewed by many as a “Merit Good” whose uniform provision reflects our distributional values.

If one agrees that public education represents an important form of income redistribution, it follows that it should be financed out of broad, ability to pay taxes.¹ Under this theory of taxation, each of us should sacrifice according to our ability to pay to support such redistributive or “Merit Goods.” Typically, a broad income or consumption tax is viewed as the appropriate instrument to effect ability to pay taxation.

Municipal services, which are of narrow benefit, on the other hand should be financed by local property taxes.

It is quite apparent that, while income and/or broad consumption taxation is a rational source of school finance, this analysis says nothing about whether or not there should be a division of responsibility between state and local government to finance public education, and what role, if any, there should be for the real property tax. However, if redistribution is a primary purpose of public education, it follows that the higher level of government (the state) has a primary responsibility to ensure that the pattern of educational services is consistent with distributional values. Given the uneven distribution of wealth, income, and differential problems of educating children, this usually leads to the conclusion of either full or very substantial state funding of local public education, and the use of equalizing state aid to poor local districts. Of course, the resulting pattern of services, taxes, and housing are important to families making location decisions. For these reasons one may argue for a *fixed* local income tax rate rather than variable ones in support of merit goods to forestall families moving because of favorable tax rates imposed to support redistributive services.² The primary rationale for a local contribution at a fixed rate of tax in conjunction with state equalizing aid is encourage local accountability which the payment of local taxes presumably engenders.

As a historical matter, local school districts were devised as an administrative means for states, often legislatures, to honor their constitutional obligations for providing “thorough and efficient” education to young people. Local school boards were devised to be instrumentalities of state government to implement state policy. To that end, taxing power was also accorded, and in the Great Depression, as states moved to excise and consumption taxes, the local property tax was reserved as the primary source of local school finance.

¹If the reader finds this unpersuasive, perhaps favoring the opposite, benefit taxes or charges on a voluntary basis to finance income redistributive services, indicates why the first argument is meritorious.

²See Nechyba(1995) for the most recent analysis of “sorting out” by families shopping among areas for local public services and housing when the public service in question is a local public good rather than a merit good or one involving income redistribution.

The chief virtues of the local property tax are usually argued to be its stability of tax base³, the fact that it already is in place, and, for some, its ability to reach to business at the local level.⁴

Aside from the problems of ensuring equitable and timely assessment practices, the local property tax is not usually viewed as an ability to pay revenue source. Indeed, the argument most often used for the property tax is that it is a benefit tax which best measures the use of municipal, as contrasted with educational, services.⁵

For especially the elderly, the illiquidity of the tax base can cause significant difficulty in complying with tax bills. It is oft-said that the local property tax extracts taxes from many who are paper-wealthy, and income poor. Also, because of lags in the assessment process, it is oft-said that the local property tax is not as elastic or growth oriented as broad-based income or sales taxes. As a result, millages must be more frequently increased with attending political disputes.

2.2 Behavioral Realism, Equity Goals, and Property Tax Reliance

Another objection to reliance on the local school property tax involves the empirical question of whether or not high wealth districts will always be able to spend more per pupil than any matching program of state aid can successfully induce poor districts to spend to adequate levels. As Feldstein (1975) pointed out, and a number of researchers have found⁶ the use of a district power equalizing formula that provides more generous matching rates to poorer districts will not in most circumstances overcome the wealth elasticity demand for educational spending. That is, the income effects will generally be stronger than the relative price effects with the result that fiscal equalization, or post-fisc equity, will not be fully achieved. For power equalizing to be effective, the elasticity of per-pupil spending with regard to wealth must be zero.⁷

Horizontal equity issues also arise once one recognizes the role of non-residential property in school finance. For some local school districts, the residential property tax is the minor

³However, see Strauss(1995) for an empirical, comparative analysis of New York State's property and income tax bases, and the finding that the local property tax base was actually *more* volatile than would have been a local income tax base.

⁴See Ladd and Harris(1995) on this; they also fashion the argument for state-wide taxation of non residential property in the support of public education with empirical analysis for New York.

⁵Helen Ladd argues that because public education may positively be capitalized into housing values, i.e. Rosen and Fullerton(1977), the local property tax is logical source of educational finance. Of course, poor education or low test scores can be negatively capitalized and thereby reduce housing values. In this case, it is not clear to me how persuasive the argument becomes.

Ladd and Harris(1995) also fashion the argument for state-wide taxation of non residential property in the support of public education with empirical analysis for New York. Also, see Ladd(1976) for an earlier analysis in the Massachusetts' context. Also, see Netzer(1966) for a general discussion of the advantages and disadvantages of the property tax, and Netzer, Berne, and Stiefel(1995) that details a variety of problems with the current New York property tax. Lankford and Wyckoff(1995) discuss the distributional aspects of New York's property tax.

⁶See, for example, DiPasquale(1979)

⁷See Reschovsky(1994) for a thoughtful review of varying concepts of fiscal equalization and school resources.

source of local revenue, while the tax on commercial and industrial property is the major source of local school finance. The presence of major utilities or shopping centers confer tax windfalls to local residents and their children, in the sense that the local costs of public education are borne by the owners and customers of these facilities rather than the residents of the school district. As a result, residents bear little of the costs of education, and can, with very low millages, provide very substantial resources to public education. Others in districts with more residential property or agricultural property, by contrast, must directly bear the burden of local school finance. Such circumstances raise questions of fairness and horizontal equity.

2.3 Replacing the School Property Tax with An Income Tax

Using an income tax to replace all or the residential portion of the local school property tax can be done entirely at the state level, or in conjunction with reforms of state school aid formulas. Replacement of the local school property tax with a foundation aid formula and a fixed, flat rate local income tax can insure that fiscal equalization, in the sense of providing the resources to support base-line educational services, can be achieved. Under a foundation grant program, the local, mandatory contribution, aid to the i 'th district, A_i , is the difference between the number of students (often weighted) multiplied times the state-defined foundation amount, F , and a state-mandated (minimum) local contribution: $t * Base_i$ where $Base_i$ is total community taxable income or adjusted gross income, and t is a mandated income tax rate:

$$A_i = [F * ENR_i] - [t * Base_i] \quad (1)$$

As of 1992, 38 states used some form of a foundation program; 23 had a mandatory local effort (a local minimum tax rate is set), while 15 did not require local effort.⁸

Under the foundation grant and local income tax approach, the crucial determination that needs to be made involves ascertaining what each district's per pupil spending needs are, the foundation amount, and then comparing this guaranteed level of spending with local resources to find a residual which the state makes up with current or augmented state resources.

It should be emphasized that the foundation amount should be a scientific measure of the resources needed to educate a child in grades K-12 to achieve at an acceptable level of performance. Indeed, one can imagine that an actual foundation amount would vary across districts once hard data were developed on what is necessary to attract and retain quality teachers, desired minimum and maximum class sizes, the sorts of capital and other operating services necessary to obtain desired levels of outcomes, differential costs of living between urban and rural areas, and the nature of the student body. That is, one can imagine determining F_i for each i 'th district by taking into account the above considerations which affect the costs of providing educational services.

⁸See Gold *et al* (1992), Table 4, p. 18.

3 The Political Economy of Financing Public Education with Local Property Taxes

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3.1 Federally Tax Induced Growth of Residential Property's Relative Tax Burden

Several explanations have been forwarded for the taxpayer revolt: (1) property taxes have grown more rapidly in the 1970's and early 1980's in key regions of states than personal income has grown; (2) while real per pupil spending has risen dramatically, outcome results such as test scores have not which in turn has tempered public support for education; ¹⁰ (3) school age population as a percentage of the total population has experienced a long term decline until recently with the implication that its political constituency has gotten smaller as contrasted with those over age 65.

While each of these factors may be at work, I would like to forward the additional empirical conjecture that there has been a long-term increase in the *relative* tax burden of residential real estate viz a viz commercial and industrial real property that has had distinct, political effects. Since home owners tend to be voters, it is this increased relative burden which has prompted the property tax revolt, and has begun to create strong interest in many states to move from the local property tax to broad based income and/or consumption taxes as happened in Michigan in 1993 and Oregon in 1994.¹¹

Several factors have slowed the growth in commercial and industrial property assessments viz a viz their residential counterparts. First, they are technically more difficult to accomplish. Second, if one looks at post-WWII federal tax policy, it has been designed with few exceptions to encourage investment in equipment rather than plant. Since federal marginal income tax rates historically have dominated business planning decisions, it should not be surprising that the plant component of investment has generally lagged. Third, if one examines long-term demographic trends, the post-WWII era witnessed an explosion in family formation and subsequent home ownership that was encouraged by favorable federal tax treatment of mortgage interest payments as well as local property taxes. Fourth, the difficulties of US manufacturing in the 1970's and 1980's was ultimately reflected in the sluggish or declining assessed values of industrial real estate. With regard to commercial real estate, the shortened federal tax lives of real property under the Accelerated Cost Recovery System in 1981 created an enormous commercial property boom which began to reduce residential properties burden in many states. However, since the creation and

⁹The analysis and empirical results here are part of a larger study on the changing role of the residential property tax and its effects on school spending.

¹⁰See Hanushek *et al* (1994) for a review of management and effectiveness issues. For evidence on the conjecture that the quality of school teachers, as measured by teacher test scores, affects pupil performance, see Strauss and Sawyer (1986), and Ferguson (1991).

¹¹This may be an example of doing the right thing for the wrong reason; however, for those who closely watch federal and state tax policy processes, this may be the norm rather than the exception.

imposition of the passive loss rules on loss income from real estate in the Tax Reform Act of 1986, investment in commercial real estate has languished, and so have their assessed values.

These stylized facts are reflected in the long term behavior of Wisconsin's residential property tax burden. Figure 1 shows that it has grown from just under 50% in 1951 to just over 66% of total taxable real estate values. After the Economic Recovery Act of 1981, residential property's share of total taxable value fell from 62% in 1981 to 60% in 1984. As useful lives were increased in 1984 and the passive loss rules put in place in 1986, commercial property became a less favored asset, and the residential share of total taxable value rose from slightly over 60% in 1984 to slightly over 66% in 1992.

Many states began to classify their property taxes and tried to forestall these long-term economic and federal tax policy induced pressures. Minnesota's local tax reform in the 1980's involved a reclassification of what had been the most heavily classified property tax system among the states. However, as is evident from Figure 2, the economic pressures in Minnesota's real estate markets have increased the burden of residential property. The reclassification in 1989 lowered the relative burden of residential property; however, it has continued to differentially grow again. Note how residential property's share of total market value of real property began to rise after 1984 in the same manner as in Wisconsin.

3.2 The Political Economy of Moving from the Property Tax to the Income Tax

Whether one replaces the school property tax with an income tax based on the normative and behavioral arguments in Section 2, the above-described economic pressures encourage state legislatures to reduce or eliminate school property taxes. However, the actual shift away from property to income taxes will ultimately raise questions about the increased first-round burden of school finance which falls on households.

While it is certain that households pay business taxes one way or another, either in their role as consumers, employees (and as actual or potential pension beneficiaries), and/or as owners of corporate interests, this perceived shift in burden will cause problems for elected officials. Several responses to this shift are possible. First, whether what we now observe represents a proper distribution of financial burden is correct or desirable is not at all clear. Certainly, forcing households to pay relatively more than they do currently may encourage greater care and interest in the spending of local school monies. If the arguments in Section

Figure 2: Fraction of Minnesota's Taxable and Assessed Value Attributable to Residential Property

2 are persuasive, then it could also be the case that business property is currently “over-taxed” in the support of local education, and the increased burden on households that results from moving to an income tax is appropriate.

On the other hand, elected officials of any political persuasion may find the shift from industrial and commercial property to households to be untenable, and argue for shifting to an income tax but, at the same time, retaining local business property taxes. If one does wish to maintain the current (or pre-reform) balance between business and household taxation¹², one may classify the local property tax, and replace only the residential property tax with a local income tax, or one can provide some form of property tax exemption (usually called a homestead exemption) which will have the general effect of reducing household but not industrial or commercial property taxes.¹³

Classification usually means that the assessment ratio applied to market value can vary by type of property or the property tax rate on assessed value can vary by type of property.¹⁴

¹²The issue of balance has been of legislative concern in other states. For example, Illinois has a constitutional provision that puts a maximum on the ratio of the state corporate net income tax rate to the personal income tax rate. In Pennsylvania, the issue of relationship between business and personal income taxes was part of the political agreement underlying a constitutional amendment permitting a state personal income tax in 1972.

¹³See Strauss(1993) for an analysis of the effects on school finances of a homestead exemption in Allegheny County, and Strauss(1995) for an analysis of the effects of replacing the residential school property tax with a local income tax and a foundation program for all school in New York State.

¹⁴The Census Bureau(1994) reports as of 1991 that 14 states permit differential assessment ratios or equalization categories—Alabama(3), Arizona(13), Colorado(3), Kansas(4), Louisiana(5), Michigan(6), Mississippi(5), Missouri(3+), Montana(9), North Dakota(4), South Carolina(7), Tennessee(3), Utah(2) and Wyoming(2). California has 2 standards for assessment that looks at date of ownership. Massachusetts and the District of Columbia permit different tax rates, while Minnesota applies “percentage adjustments” to

It should be noted that the business community often finds offensive the differential classification of real property in terms of tax rates or stated assessment ratios. Their concern revolves around the possibility that business property will be more heavily taxed than before once it is isolated from residential property. There are a number of techniques to forestall such subsequent fiscal shifts. One way is to provide through state law mandatory assessment ratios for different types of property, and provide for reasonable standards of evidence upon appeal. Alternatively, if 100 percent market value is the assessment standard, then state limitations on differential millages can be provided through law, again with reasonable standards of evidence upon appeal. To the extent that movement from the residential property tax to a local income tax is at the discretion of local school districts, then one can require that personal income tax receipts be offset, dollar for dollar, by local residential property tax reductions, and/or provide for a limited amount of revenue growth (inflation plus enrollment growth rates, for example).

As may be obvious to some, the wholesale replacement of the local property tax by local income taxes will move the relative burden of school finance further to households as contrasted to the non-household sector since there will be no corresponding local (or state) non-household income tax increase to compensate for the non-household property tax decrease. What the ultimate incidence of such changes can be depends not only on examining local factor markets, but also depends on how factor market effects work through to product markets. One may conjecture that taxpayers *as* voters ignore these indirect or general equilibrium effects.

4 Conclusions

I have sought in this paper to examine the normative, behavioral, and political economy arguments for the desirability of moving from the local school property tax to an income tax to finance public education. To summarize: education should be financed by ability to pay taxes, and the property tax does not qualify as such a revenue source. The widespread dislike of the local school property tax can be attributed to the growing residential share of the burden. The inherent problems in assessing commercial and industrial property, coupled with sluggish or declining economic values of manufacturing assets and the 1986 passive loss rules with respect to income earned from real estate, have had the economic effect of making residential property relatively more valuable in many states.

The difficulties one faces in moving from the local school property tax involve: finding adequate state level substitute revenue sources, as well as a local income tax and state aid formula that achieves fiscal equalization goals. A foundation approach to funding a basic education level, that can still vary by cost of living and student's needs, coupled with a fixed rate local income tax can do much to improve the equity of school finance. Whether more rationally raised revenues can also improve educational performance remains an outstanding research issue, and one that deserves continued interest by the public finance community.

market value data to achieve classification.

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