The Property Tax and the Search for New Revenue Sources

by Charles D. Liner

Summary

The tension between increasing demands at the local level and the unpopularity of the property tax has forced elected officials to seek other means to pay for services. But the author, Charles D. Liner, a faculty member specializing in tax issues at the University of North Carolina at Chapel Hill’s Institute of Government, argues that this move to alternative revenue sources is shifting the burden of paying for local services to those less able to pay. The worst case example is the uniform per household fee the General Assembly has authorized for such services as landfill operation. Such charges—often described as user fees—would more accurately be characterized as flat taxes. The author argues that such taxes are highly regressive. They have much in common with the poll tax, now unconstitutional in North Carolina, because they are applied uniformly on a per household basis. Other alternatives, while less regressive than the flat tax, attempt to shift the tax burden to citizens outside the jurisdiction where the bulk of local services are provided. Examples are the hotel-motel tax and the entertainment tax, authorized for some local jurisdictions, and the payroll tax, which so far has not been authorized in North Carolina.

The author argues that there are two generally recognized principles of tax fairness—assessment according to ability to pay and assessment according to level of benefits received. The alternative revenue sources being sought by local governments often violate one or both of these principles in a manner worse than the property tax. The author discusses the strengths and weaknesses of the property tax and considers some of the features that may make it less popular with the tax paying public. Yet he argues that the property tax is a true local tax in that local elected officials set the rate and can be held accountable by the taxpayers for spending decisions. Before the shift to alternative revenue sources progresses much further, the author advocates more discussion of a fundamental issue: what kinds of revenue sources will assure that the costs of financing government services are distributed equitably among the people?

A companion piece by Mike McLaughlin, editor of North Carolina Insight, discusses various avenues the legislature could pursue to ease the fiscal stress on local governments in North Carolina. This stress is created in part by increased service demands at the local level and increased reluctance among local officials to raise the property tax to pay for services. In response, the N.C. League of Municipalities and the N.C. Association of County Commissioners have proposed broader local government taxing authority through a tax menu that would allow local government officials to choose from an array of additional revenue raising options. The article discusses the pros and cons of such a menu and explores other possibilities for easing the fiscal stress on local government.

In conclusion, the N.C. Center for Public Policy Research offers four options the General Assembly could pursue: (1) a tax menu for local government that includes authority to levy one or more of the following: a hotel/motel occupancy tax, a local land transfer tax, a prepared food and beverage tax, an amusement tax, a 1-cent increase in local sales tax authority, or a local option income tax; (2) authorization for a 1-cent increase in the local-option sales tax only; (3) relief for local government from the cost side through the state’s assuming the local share of expenditures for Medicaid, Aid to Families with Dependent Children, and Special Assistance for Adults; or (4) take no action to relieve the fiscal needs of local government and let local government officials rely on further cost-cutting and privatization while paying less attention to rising service demands and capital needs.
North Carolina's local government officials are searching for new revenue sources. For many years, they have called for the General Assembly to authorize a variety of new revenue sources that can be used instead of the property tax. Already they have sought and received authority, through both general and local legislation, to levy a number of new taxes. The increasing use of these new taxes is changing local taxation and the distribution of tax burdens among North Carolinians. So far these changes have been based largely on the simple rationale that local governments need more revenue and therefore they need new revenue sources. There has been little discussion of why people should be taxed under the new revenue sources rather than the existing property tax.

The revenue sources used by a state and local government determine how the costs of providing government services are distributed among the people. The key issue for North Carolinians, therefore, is whether existing and proposed taxes, charges, and fees distribute the costs of government in a "just and equitable manner," as the state constitution requires.

Providing for Local Revenue Needs

North Carolina's constitution gives the General Assembly exclusive power to authorize taxes for local governments. The constitution vests legislative power with the General Assembly and specifies precise procedures for enacting taxes or allowing counties and cities to impose taxes. Further, the constitution requires that "the power of taxation shall be exercised in a just and equitable manner, for public purposes only, and shall never be surrendered, suspended, or contracted away."

Given the authority to raise revenue that the General Assembly already has granted, are local governments able to raise the revenues they need? Strictly in terms of legal authority, the answer is yes.
“Our new Constitution is now established, and has an appearance that promises permanency; but in this world nothing can be said to be certain, except death and taxes.”
—Benjamin Franklin

North Carolina’s cities and counties have authority to increase their revenues greatly by increasing rates on the property tax. Of course, where population and economic growth (and inflation) cause the property tax base to grow, revenues will increase without rate increases.

There are some legal limitations on property tax rates, but in fact they are not real constraints. There is no rate limit for property tax revenues used to pay for schools, social services, jails, and debt service, for example. To finance most other services, the combined property tax rate can equal as much as $1.50 per hundred dollar valuation, and voters can approve increases above that rate. North Carolina’s cities and counties are not close to being constrained by these legal limitations.

But it’s a different matter entirely when we consider political constraints on raising more revenue through the property tax. Elected local officials everywhere are under constant fiscal pressure for many reasons—population growth, school enrollment growth, inflation in medical care and other costs, costs imposed through federal and state mandates, and likely cutbacks in federal grants. At the same time, they are under constant, intense pressure to keep property tax rates from rising. Nowhere else in our system of governments is there such a direct link between the spending decisions of elected governing officials and the taxes that people pay. That link is so direct at the local level that spending decisions often are quantified not just by dollar amount but by the number of pennies of the tax rate that the spending represents.

This direct link is good in that it makes local officials highly accountable to local taxpayers. But it can have paralyzing effects on local governments that leave critical needs unmet. This is not a new problem, of course, for it has long been recognized that placing responsibility for financing services at the local level will result inevitably in disparities in spending and service levels and inadequate levels of service in some units. The problem is especially critical when local governments are asked to raise taxes to pay for services that need to be provided uniformly across the state.

Since 1900, the state’s solution to this problem has been to shift financial responsibility for certain critical services to the state level. Since 1931, the state has assumed primary financial responsibility for what were originally the major county responsibilities—public schools, roads and highways, prisons, and the judicial system. Altogether, about 70 percent of state spending goes to finance programs administered by local governments, such as public schools, public health programs, and social services programs (including such major programs as Aid to Families with Dependent Children and Medicaid).

State taxes now account for almost three-fourths of combined state and local taxes. The property tax, which financed over 90 percent of state and local spending in 1900, now finances only 12 percent of spending and accounts for only 20 percent of state and local tax revenue. North Carolina ranks 39th among the 50 states in per capita property tax revenues.

But reduced reliance on the property tax has not eliminated pressure on the property tax. At least for the past three decades, and particularly during the past decade, local officials have searched for ways to keep property tax rates low by raising revenues through other means.

The Search for New Revenue Sources

The major changes have been: (1) an increased reliance on user charges and fees; (2) a major shift from the property tax to retail sales taxes; (3) an increased reliance by some units on specialized sales taxes authorized by local acts; and (4) an increasing reliance on flat taxes levied on households and other bases such as sales of new homes, telephone bills, and motor vehicles.

The search for alternative revenue sources has led local officials to become very aggressive in using charges and fees as a revenue source by increasing revenues from existing charges and by inventing new ones.
User charges and fees. User charges long have been used to finance certain services that directly benefit individuals and for which benefits to individuals can be assessed and charged, such as water and sewer services, parking, airports, bus transportation, ambulance service, recreation and cultural programs, and some public health and mental health programs. Fees typically are used to finance administrative costs incurred in regulatory programs. Some examples are fees charged for building inspections and health and sanitation inspections.

The search for alternative revenue sources has led local officials to become very aggressive in using charges and fees as a revenue source by increasing revenues from existing charges and by inventing new ones. Some units have adopted policies that certain services, such as building inspections, must be financed wholly from fees (though some benefits of these programs accrue to the community at large). Many recreation programs that once were offered free to encourage participation—such as children’s baseball or basketball leagues—are now open only to those who can pay.

Local retail sales taxes. There has been a major shift from property taxes to retail sales taxes, which now are equivalent to about one-third of total property tax revenue and account for about one-fourth of total local government tax revenue. In 1971, four years after Mecklenburg County received authority to levy a local retail sales tax, the General Assembly authorized all counties to levy a one-cent local retail sales tax, which is collected by the state and returned to the county and municipal governments in the county where it is collected. In 1983 and again in 1986, in response to calls for state financial assistance for water and sewer facilities and school construction, the General Assembly authorized two additional half-cent local retail sales taxes, the proceeds of which are distributed according to county population rather than county collections. Municipalities have been required to spend a portion of the proceeds only for water and sewer facilities for 10 years and counties have been required to spend a portion for school construction projects for 16 years.

Local authority for new special sales taxes. On their own, many local government units have sought and received authority to levy several taxes that fall on sales of various items. The most common of these is the occupancy tax, which is a sales tax on the use of hotel rooms and similar accommodations.
tax on rentals of hotel and motel rooms and other lodging. Several northeastern counties have received authority to levy what is called a land transfer tax, which is imposed as a percentage of the value of real property transfers. Greensboro has been authorized to levy an admission tax, which is imposed on events at the Greensboro Coliseum. In 1990, the General Assembly authorized a "prepared meals" tax for Charlotte and Mecklenburg County to support convention center facilities and convention promotion. This is an extra sales tax on the price of meals and prepared foods purchased in restaurants and other establishments that sell food. Municipalities that have since received authority to levy such a tax are Hillsborough and Raleigh. The counties of Cumberland, Dare, and Wake also have received this authority.

Flat household taxes. In trying to find ways to avoid property tax rate increases, local governments have invented a form of tax which might be considered new, except that this type of tax is very similar in nature and effect to highly regressive poll taxes (also called head or capitation taxes) that became unconstitutional after voters approved an amendment in 1969 ("No poll or capitation tax shall be levied. . ."). These taxes are all similar in that they are levied as a flat amount on some base that has no relationship to actual use of or benefits received from the services financed with the tax (unlike bona fide charges and fees), or to the value of the item taxed (unlike sales or property taxes), or to taxpayers' ability to pay (the rich pay the same amount as the poor).

The use of these flat taxes apparently began during the 1980s when some units began to impose a landfill or waste collection "user charge" or "user fee" that was billed to each household and collected through the property tax billing system. In the past, landfill costs have been financed primarily through the property tax except for tipping fees, and publicly operated waste-collection services usually have been financed from the property tax. Although they are usually called charges or fees, these actions are taxes because the amount imposed does not vary with use of the landfill (as tipping fees do) or the amount of garbage collected (though a few units do charge for waste collection through volume-related charges).

In 1989 and 1990, some time after these taxes were first used, the General Assembly authorized certain units to collect them using the property tax billing and collection system (so their payment could be legally enforced), and in 1991, it granted general authorization for doing so. These taxes are
imposed on “improved” property—vacant land is not taxed. The taxes on apartments and mobile homes in rental spaces are collected through the landlord. The enabling law referred to these taxes as “availability charges,” the inference being that residents are being charged not for use of the landfill but for its availability.8 Following that logic, any tax could be called a charge for the availability of government services.

In 1991, the General Assembly authorized local units to collect charges for stormwater facilities and public enterprise activities9 through water bills or other billing systems such as electricity billing.10 This authority could pave the way for additional flat taxes based on the same rationale as availability charges. However, such charges do not have to be flat taxes. The first use of stormwater charges, for example, has been to relate them to benefits by basing the charges on impervious coverage area such as buildings or pavement.

The N.C. Department of Revenue does not keep track of these flat household taxes, as it does other local taxes, because they are not officially designated as taxes. One unofficial and perhaps incomplete survey by the N.C. Association of County Commissioners from 1993–94 shows that about 40 counties are imposing annual flat “household disposal fees” for landfill costs that range from less than $15 to $75. In 25 counties, the amount exceeded $30, and in 11 counties, the amount exceeded $50. Only one county imposed the charge on businesses (perhaps because commercial waste disposal firms that serve businesses already pay disposal fees at the landfill). Some of these counties also impose a flat “household collection fee.” For example, in one rural county, residents pay a $60 collection fee and a $40 disposal fee. Other counties included the fee for disposal in the collection fee. The collection fees typically ranged between $30 and $60, with a few exceeding $90.

Though it might appear to some people that these amounts are low in relation to the property taxes they pay, for a great many North Carolinians these charges can be large in relation to their property taxes. Using 1994–95 tax rates and official assessment ratio surveys, it appears that in half the counties the county property tax on a home with a market value of $50,000 would be less than $300 (the estimated taxes fall in a range from $165 to $295). A household disposal fee of $50 is equal to 17 percent of a property tax of $300. The fee would be even more substantial in relation to property taxes on mobile homes.

Other flat taxes. If flat taxes can be rationalized as a way to charge households for the availability of the landfill, could not the same rationale be used to justify flat taxes for public schools, law enforcement, fire protection, and public health? In Orange County, a flat tax already is being used to pay for school construction. That county imposes a flat tax of $750 on new homes, apartments, and mobile homes; the tax is $1500 inside the Chapel Hill-Carrboro school unit boundaries. This excise is called a school construction impact fee because it is intended to help pay for school construction needs resulting from population growth. But, of course, not all new homes are purchased by families with children. Orange County found that an average of one-third of a school-aged child lived in each new home, apartment, and mobile home in the county school district. And not all in-migrating children live in newly constructed homes and apartments. So this excise is actually a tax imposed on the sale of new homes.

Another flat tax, authorized for all local government units in 1989, is a monthly charge of up to $1 on each telephone bill to pay for 911 emergency telephone systems.

Another form of flat tax is levied on motor vehicles. Municipalities have long been authorized to collect a license tax on each motor vehicle,11 but because the authorized fee is only $5 per vehicle, many of them have not found it worth the trouble to collect or enforce this tax. In recent years, however, a number of municipalities have requested and received authority to impose the tax at a higher rate. Two of them, Charlotte and Matthews, are authorized to charge $30 per vehicle,12 which is more than the state vehicle license tax (part of the proceeds can be designated for public transit). Unlike the state license tax, however, revenues from these taxes are not necessarily restricted to road-related spending. In fact, Alleghany County collects $10 per vehicle and devotes the revenues to economic development programs.13

A similar flat tax on vehicles was created in 1991 when the General Assembly authorized a vehicle registration tax of $5 per vehicle to be imposed by regional transportation authorities14 (it is in use in the Research Triangle area), and in 1993, it authorized a similar tax to be levied in counties comprising the Global TransPark Development Zone to support economic development and infrastructure projects within the zone.15

Other proposed taxes. Other new local taxes have been proposed but not authorized so far. Some local officials would like to have authority to levy additional retail sales taxes in their counties, and
The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities.

—ADAM SMITH

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bills have been introduced to increase the authorized retail sales tax rate again to raise additional money for school construction. At least two counties have considered use of a payroll tax, which would be imposed as a percentage of the pay of all who work within a jurisdiction (including those who commute from other jurisdictions). The idea of having a local income tax tied to the state income tax has been mentioned occasionally, but there seems to be little interest in it. Such an income tax would fall only on those who live in the unit that levies it.

Issues Involving New Revenue Sources

The revenue sources that counties and cities use to finance government services determine how the burden of financing public services will be distributed among the people. The paramount issue in tax policy is whether the tax system distributes that burden in a way that is fair—or in the words of the state constitution, whether the power to tax is exercised in a “just and equitable manner.”

There are two commonly accepted principles of fairness in taxation, the benefits principle and the ability to pay principle. The benefits principle of taxation calls for the costs of government services to be distributed according to the benefits received from those services—and those who benefit more should pay more. Thus, charges, fees, and taxes (such as gasoline taxes used to finance streets and roads) that vary with actual use of a public service help to make the distribution of burdens fair.

There are fundamental problems that restrict the use of benefits-related revenue sources. First, the nature of many public services is such that the benefits accrue generally to the public and, therefore, cannot be assessed and charged to individuals. Water and sewer services can be metered and billed, and water can be shut off if bills are not paid. But there is no way to make individuals pay voluntarily for services that benefit the entire community.

For example, everyone in a community is benefitted when the police department makes streets and homes safe and secure. Can we charge people for those benefits? If we billed every household for an equal share of the cost of supporting the police department, people could throw away their bills without paying them and still enjoy the general benefits of safety and security provided by the police department. If every household were forced by law to pay those bills (say, by collecting them through the property tax billing and collection system), we would not have a bona fide user charge because the amount paid would not vary with use or benefits received. Rather, we would have a flat household tax.

Because individuals cannot be charged or billed for services that provide general benefits to the community, we must impose taxes—we must force people to pay—according to some base that results in a fair distribution of tax burdens. The principle of fairness that applies to these general taxes is the ability-to-pay principle. This long-accepted principle (it dates back at least to 1776 and the writings of Adam Smith, the intellectual father of free market economics) calls for state and local revenue systems to distribute the burden of financing public services as nearly as possible based on people’s ability to pay. “The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective abilities...,” wrote Smith.

Many people would argue that those with higher incomes should pay a higher proportion of their income in taxes than lower income people—that taxes should be “progressive.” But this principle does not necessarily call for progressive taxes, and certainly does not require that every single tax be progressive (for example, a progressive state income tax can offset the regressivity of other state or local taxes). It does not mean “soaking the rich” to pay for services for the poor or for redistributing income through taxation. It merely calls for overall tax burdens to be proportional to ability to pay.

Taxes that impose the same absolute burden on the poor as on the rich would certainly violate this principle. A tax that imposed a higher relative bur-
den on the poor than on the rich would also violate it. In that case, higher income people might pay more in absolute amount, but the tax as a proportion of income would be less than it would be for lower income people. When a tax imposes a higher relative burden on poorer people than on richer people, it is “regressive” with respect to ability to pay—tax burdens relative to ability to pay are highest for those with the least ability to pay. Almost everyone would agree that such taxes are unfair.

Yet almost all the local taxes that have been adopted in recent years are regressive taxes, and the new flat household taxes are as regressive as a tax can be. Almost any tax on sales will be regressive because poorer people spend a higher percentage of their income than others on most goods and services. There are some minor exceptions to this rule. A sales tax on luxury items bought only by the wealthy, such as airplanes, might be progressive. The occupancy tax on hotel and motel rentals might be substantively less regressive than other sales taxes. The prepared meals sales tax also might not be as regressive as some sales taxes, though it does fall on people who eat at fast-food restaurants as well as those who eat at fancy restaurants.

Genuine user charges and fees—those that are tied to use of services—are fair in accordance with the benefits received principle of fairness but nevertheless are regressive with respect to ability to pay. They are especially regressive when, as in the case of water and sewer bills, they include a flat administrative charge along with a volume-related charge. A payroll tax, unlike a general income tax, would be regressive because it falls only on wages, whereas higher income people tend to receive more of their income from non-wage sources. In addition, payroll taxes do not shelter subsistence levels of income through personal exemptions and standard deductions, as general income taxes do.

But the most regressive of the new revenue sources is the flat household tax. Purchases of items subject to a sales tax do increase with incomes so that those with higher incomes at least pay more taxes in dollar amount (though less as a percentage of income) than do those with lower incomes. But a flat household tax imposes the same dollar amount of tax on everyone. Thus, the richest household pays the same tax as the poorest household, and that tax as a percentage of income is dramatically higher for lower income households. For example, a flat household tax of $50 equals 1/200ths of the income of a family that earns $10,000 (0.5 percent) but only 1/2000ths (0.05 percent) of the income of a family that earns $100,000.

The Property Tax

Ironically, the current form of the property tax originally was intended to achieve tax fairness by replacing a regressive system of flat taxes. Although the property tax in various forms goes back to ancient times, the current form—a tax on the value of property—dates from 1776, when North Carolina became a state. During the colonial era, the principal taxes were the poll tax and a property tax on land acreage. Both these taxes were regressive with respect to ability to pay because they were imposed as a flat amount per person or per acre, respectively, without regard to income or value of land.

When the General Assembly first convened in 1776, the first law enacted authorized a state militia and the second law authorized a new tax system that would fall on the value of all forms of property. This reform was short-lived, but beginning early in the 19th century, the state again moved to replace the per-acre property tax with a property tax levied according to value. In doing so, the state was following a nationwide movement based on a concept of tax fairness that called for all forms of property—including land, improvements, and personal property such as household property, inventories, and intangible property like stocks and bonds—to be taxed according to its value. Eventually this concept of “universal and uniform” property taxation was incorporated into the 1868 constitution. The concept that all forms of property should be taxed was followed in the main until the last decade, when the General Assembly exempted personal property, business inventories, and intangible personal property (local governments have been reimbursed for the revenue they lost as a result of these exemptions but have lost some of the revenue growth that would have occurred.)

Thus, today’s property tax is based on an early,
19th century, pre-industrial concept of taxation according to ability to pay, in which property, or wealth, was considered the proper measure of ability to pay. As the state began to shift from an agrarian economy to an industrial economy, the association of property ownership with economic well being and ability to pay became weaker. Income, not property or wealth, is regarded today as the appropriate measure of ability to pay, and income taxes are regarded as the most effective and equitable means of taxing people according to their ability to pay.

Another effect of the shift to an industrial economy was that incomes and property tax bases in the various counties became increasingly uneven. Until about 1900, county government was responsible for administering and financing most services, including public schools, public health, jails and prisons, public welfare programs, and roads. The ineffectiveness and inequity of supporting statewide services from local taxes became apparent at that time, mainly in the case of schools, and the state government began to assume a greater responsibility for financing such programs.

**The ability to pay principle.** The key issue regarding the property tax, as with any tax, is whether it is fair. How does it measure up in terms of the benefits received and ability to pay principles of tax fairness? Let us consider first whether the tax is fair according to the ability to pay principle, because the tax was originally intended to achieve taxation according to ability to pay.

That turns out to be a very difficult question, so difficult in fact that we cannot simply label the property tax as regressive or progressive, fair or unfair. The answer depends upon the assumptions one must make about the final incidence of the tax. In the traditional analysis common before the 1970s, the property tax was assumed to fall in proportion to consumption—the portion of the tax that falls on housing is borne by the owners or renters, and most of the portion that falls on businesses is passed on to consumers. The conclusion therefore was that, like any tax that falls on consumption, the tax is regressive.

During the 1970s, economists began to use a different, more sophisticated analysis that takes into account the broad economic effects of the property tax and the implications for returns on property investment. Because investors in property cannot avoid paying some amount of property tax by shifting investments from one jurisdiction to another, at least some level of property taxes must be borne, through lower rates of return on investments, by

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*Mecklenburg County Courthouse, Charlotte, 1898*
property investors and ultimately, after market adjustments, by owners of investment capital. That burden will be progressive, because ownership of capital is concentrated among upper-income people (though part of the burden could still fall according to consumption).

Thus economic analysis of the tax’s incidence is inconclusive or contradictory, and therefore we cannot judge the fairness of the property tax simply by applying the labels regressive or progressive. How then can we judge the fairness of the tax in relation to proposed alternative revenue sources? Two approaches are possible.

First, we can adopt the reasonable assumption that the burden of property taxes on family residences is borne by the families who own them. We can then estimate property taxes for families with different incomes based on surveys of family spending on housing. Such estimates suggest that the property tax is somewhat regressive for families in the mid-range of income. For example, estimated property taxes, assuming a rate of 1 percent of market value, would equal 1.6 percent of the income of a family with income of $18,000 and 1.2 percent of income of a family with income of $60,000. The degree of regressivity in this income range is about the same as that for retail sales taxes.

But this approach also has shortcomings. It does not take into account that property values are higher in urban areas than in rural areas, that municipal residents pay more in property taxes than non-municipal residents, that assessment accuracy varies, and a host of other problems. We do not have needed data on spending and property ownership of upper-income families, and this approach provides no help in estimating property and sales taxes paid by businesses and owners of commercial and agriculture property.

A second approach is the common-sense approach of examining, on the basis of hypothetical cases, how changes in taxes might affect different people and different businesses in the community. For example, what effect would the substitution of a flat household tax or additional retail sales tax for property taxes have on the taxes paid by a typical bricklayer, store clerk, bank manager, corporate executive, or brain surgeon? This approach may not give complete answers in all cases, but in some cases, such as the substitution of flat household taxes for property taxes, it gives very clear and credible results.

Before leaving the question of how property taxes are related to ability to pay, it is important to mention that the property tax has one critical drawback in this regard. Though property ownership might be correlated with income, there is no direct relationship of property tax liabilities to income. Income taxes increase only if one’s income increases, and they fall if one’s income falls. One pays more in retail sales taxes only if one can afford to spend more on taxed goods and services. But one’s property taxes can increase substantially—either because tax rates increase or because property values increase—without regard to one’s income. This aspect of the tax undoubtedly creates uncertainty, resentment, and even fear that contributes to public attitudes about the tax.

Some states have addressed this problem, at least for the elderly, by instituting a state-financed “circuit-breaker” system that prevents property taxes from exceeding a prescribed percentage of income. North Carolina authorizes use-value assessment of farmland and provides a homestead exemption for low-income elderly people, but those measures do not prevent the property tax from “overloading” income.

The benefits principle. The property tax is a general tax intended to finance the general, community-wide benefits of public services, and therefore it is imposed on the assessed value of property without regard to the specific benefits that accrue directly to owners of property. For example, one pays county property taxes to support the local share of school expenses even if one has no children in the public schools. Even so, there are a number of ways in which the property tax is associated with benefits received from public services. Many local services, such as fire and police protection, provide benefits directly related to property and perhaps to the value of property. A community that has excellent public services or excellent schools might see that excellence reflected in higher property values. A community that cares little for public service can enjoy a low tax rate, while another community that values public service can impose a higher tax rate. As discussed later, the property tax fits well into North Carolina’s system of municipalities. Municipalities provide an additional level of services not provided to those who live outside municipal boundaries, and municipal residents must pay an additional property tax, in addition to the countywide property tax, in compensation for the extra benefits they receive.

Shifting Tax Burdens

How do tax burdens shift among residents when a flat household tax or an additional retail sales tax is substituted for the property tax? Those
who benefit most from such changes are those who own the most property—owners of expensive homes, large amounts of agricultural and forest land, or valuable commercial property.

In the case of flat household taxes, this conclusion follows from simple arithmetic. If, for example, a household disposal fee of $50 permits a county to lower property tax rates by 5 cents per $100 valuation (or, conversely, to prevent a rate increase of that amount), the owner of a residence assessed at $100,000 will save $50 in property taxes and the owner of a residence assessed at $300,000 will save $150 in property taxes, but both will pay the same $50 disposal fee. The owner of a commercial building assessed at $10 million will save $5,000 in property taxes and will not have to pay the disposal fee if it is not imposed on businesses.

To illustrate how a shift from property taxes to sales taxes would benefit large property owners, we have to use simple logic rather than simple arithmetic, because we do not have data on property and sales taxes paid by wealthy families and businesses. An increased sales tax rate would produce a certain amount of revenue for a local government, which would enable it to lower the property tax rate or, conversely, to increase spending without raising the property tax rate. The benefits that accrue from the reduction in the property tax rate would, as in the former case, increase with the value of the property owned.

But how much would those taxpayers pay in additional sales taxes? We know from available spending data for families of moderate income that retail sales taxes fall as a percentage of income as incomes rise, and we can assume with confidence that percentage continues to decline as family incomes increase. Thus, wealthy taxpayers who own expensive property, such as expensive homes or commercial property, are likely to benefit more than taxpayers of moderate income from a reduction in the property tax rate, but the increased sales tax that they pay will be comparatively modest in relation to income.

Owners of commercial, industrial, and agricultural property also would benefit from property tax rate reductions in proportion to the assessed value of their property, and those benefits to owners of valuable property are likely in most cases to be greater than the resulting increase in local sales taxes. An owner of a large commercial office building, for example, is likely to get a substantial reduction in property taxes compared with modest increases in sales taxes on purchases of such items as office and maintenance supplies (sales of fuel are not subject to the local sales tax). In addition, manufacturers and farmers pay a lower state sales tax on certain items, such as fuels used in production processes and certain equipment and therefore these purchases are not subject to local sales taxes (which fall only on items subject to the regular state sales tax rate).

Substituting flat household taxes for property taxes. Let's consider the hypothetical case of a bricklayer who earns $25,000 and lives in a home assessed at its market value of $50,000, and a bank manager who earns $75,000 and lives in a home assessed at its market value of $150,000. Let's suppose that a county's landfill costs are equivalent to revenue generated by five cents of its property tax rate, but it seeks to raise that amount of money instead through a new flat tax of $50 per household (while keeping the property tax rate the same so that total revenues are increased).

The 5 cent property tax rate implies that the bricklayer pays $25 in property taxes to support landfill costs, or 0.1 percent of his income. The bank manager pays $75 in property taxes for that purpose, which also equals 0.1 percent of his income. Under the assumption used here that housing values are proportional to income, a property tax would have imposed tax burdens on these two households in proportion to their income. (In reality, housing values might decline slightly with income in this range of incomes.) On the other hand, the flat tax of $50 represents two-tenths of one percent (0.2 percent) of the income of the bricklayer, but only seven-hundredths of one percent (0.067 percent) of the bank manager's income.

If we assume, for the sake of illustration, that the total property tax rate in the county is $0.50 per hundred dollar valuation and that the property tax rate is not actually reduced when the flat tax is im-
posed, the additional flat tax represents a 20 percent tax increase for the bricklayer but only a 6.7 percent tax increase for the bank manager.

The shifts in tax burden demonstrated in this example become more striking if we extend the hypothetical case to include a store clerk who earns the minimum wage and owns a mobile home assessed at $10,000, and a doctor who earns $250,000 and owns a home assessed at $500,000. The flat tax of $50 on the store clerk represents a 100 percent tax increase for the store clerk and a two percent tax increase for the doctor.

**Substituting retail sales taxes for property taxes.** How do tax burdens shift when a retail sales tax is substituted for county and municipal property taxes? Though there would be significant shifts from large property owners to ordinary taxpayers, among ordinary taxpayers of moderate income, the shifts are not likely to be nearly as great as in the case of flat household taxes. Although the retail sales tax is a regressive tax, as a percentage of income the tax does not fall dramatically for people in the midrange of incomes. For example, the two percent local retail sales tax would represent an estimated 0.6 percent of the income of a family with income of $20,000 and 0.4 percent for one with income of $65,000.

Relative spending on housing and housing values are also likely to fall, if only slightly, with increases in incomes in this range, so the net burden of shifting from the property tax to a retail sales tax is likely to be relatively modest for taxpayers of moderate income. As noted before, the big gainers would be owners of large amounts of property. They stand to save substantially on property taxes relative to the modest increase in sales taxes.

Another factor must also be considered here. North Carolina has a two-tiered system of local government services. That is, counties provide certain services such as public schools, social services, and public health on behalf of everyone in the county, while municipalities provide additional services, or a higher level of services (such as fire and police protection), to those who live within municipal boundaries. This two-tiered service system is matched by a two-tiered property tax system. Everyone who lives in the county, including those who live in municipalities, pays the county property tax rate, and those who live in municipalities pay an additional municipal property tax in compensation for the additional benefits they derive from municipal services.

**Demand for new infrastructure, like this water plant below, is one factor increasing costs for local government.**
When a retail sales tax is substituted for the property tax, as occurred in 1971, 1983, and 1986, this two-tiered tax system breaks down. That is, everyone in the county pays the same sales tax, according to his or her spending for taxable items. But municipal governments as well as the county government get a share of the proceeds, so municipal residents do not pay an extra tax to compensate for the extra benefits they receive from municipal services financed through the sales tax revenues. There are still two levels of service but only one level of sales taxes. The municipal residents of a county can benefit from additional municipal services financed by the municipal share of the sales tax while paying the same tax as a non-municipal resident of the county who does not receive those benefits.

**Taxing Non-residents**

A characteristic of many of the new revenue sources proposed by local officials is that they fall substantially on non-residents, as well as on residents. Are local governments justified in wanting to impose additional taxes on those who live elsewhere, or are the proposed taxes merely a way to export tax burdens to outsiders?

The great advantage of the property tax in a state and local system of government is that it distributes the costs of government services mainly to those who live in, or do business in, the community that levies the tax and who enjoy the benefits of those government services. But non-residents can also benefit from the services provided by a local government. For example, people commute to other towns and counties to work, shop, and do business, or to visit beaches, parks, museums, stadiums, and civic auditoriums. Should they not be taxed by the local government that provides services which benefit them?

The property tax already falls partly on non-residents, either directly or indirectly. Non-residents who own property in a community have to pay property taxes to the local government. Businesses in the community will attempt to pass their property taxes on to the consumers of their products and services through the prices they charge. In this way, the cost of providing services to businesses is passed on, at least partially, to those who purchase those products or services, whether or not they live in the community.

Communities that serve as regional employment, shopping, and entertainment centers also will be compensated at least in part for the services provided to non-residents through the revenues that result from increased employment, income, and property tax base. Indeed, local governments actively seek to attract business firms to their communities and often provide financial subsidies and inducements to them, on grounds that the community as a whole will benefit from additional employment, income, and property tax base (which, other things being equal, reduces property tax rates for residents). Similarly, local governments often justify the use of public funds to subsidize civic auditoriums, stadiums, and museums on grounds that such projects will provide additional jobs, income, and tax base.

Still, many of the new revenue sources in use or proposed for use impose additional taxes on non-residents. The City of Hillsborough exports part of its taxes through the prepared meals tax to the travelers on Interstate 85 who stop to eat at its fast food restaurants. Part of Mecklenburg County’s prepared meals tax (the part not paid by local residents) falls on outsiders who attend conventions there. Dare County keeps its property taxes low by levying a land transfer tax that falls mainly on outsiders who buy beach property. The occupancy tax falls mainly on outsiders, since local residents only seldom rent local hotel and motel rooms. An admission tax can collect revenues (in addition to revenue from user fees and ticket sales) from rock music fans or sports fans from miles around. A local retail sales tax whose proceeds are returned to the county where they are collected, such as the one-cent retail sales tax enacted in 1971, allows counties that serve as regional employment and shopping centers to collect sales taxes from shoppers who live elsewhere. A payroll tax would permit regional centers like Mecklenburg to impose a tax on wages of all who work there, including those who commute from South Carolina and surrounding North Carolina counties. (Unlike a payroll tax, a local income tax levied on state tax liability would fall only on local residents.)

A key issue in evaluating these revenue sources is whether they conform to the benefits received and ability to pay principles of tax fairness. Do commuters, non-resident shoppers, tourists, and visitors who travel to another city or county impose costs on the community that are not already compensated through the existing system of taxes, charges, and fees (such as fees imposed for use of civic auditoriums and even tickets)? The state maintains the highways, roads, and thoroughfares that non-residents mainly use, and cities receive a share of the gasoline taxes collected to defray their street costs. As noted, the owners of office buildings, ho-
tels, shopping centers, and factories pay property taxes in compensation for the costs of providing services enjoyed by the owners and the people who use these facilities, and the eagerness of local officials to encourage and even subsidize these facilities suggests that local communities get substantial net benefit from them.

A land transfer tax might conform to the benefits of tax fairness in a resort community where most of the services financed by the tax benefit the property on which the tax is imposed. But in non-resort communities, is it fair to impose taxes only on those people who purchase property, when other people also enjoy the benefits of government services? Is a payroll tax, which falls only on wage income and does not permit personal exemptions, fair in accordance with the ability to pay principle (as well as the benefits received principle) of tax fairness?

Conclusion

The search by North Carolina’s local officials for new revenue sources is leading to fundamental changes in the state’s system of local government taxation. These changes have been occurring in piecemeal fashion, with little public discussion or even public recognition of the substantial shifts in tax burdens that ensue from them. Before recent trends progress much further, it is important for the state to begin a discussion of a fundamental issue: what kinds of revenue sources will assure that the costs of financing government services are distributed equitably among the people?

Inherent in this issue is the question: what role should the property tax play in North Carolina’s system of state and local government? Whatever its faults and however unpopular it might be, the property tax remains the only major tax, other than a local income tax tied to state income tax liabilities, that can serve as a truly local tax. It is a local tax because it makes local officials and local taxpayers accountable. Elected officials, who make spending decisions and set the tax rate, are accountable to local taxpayers. If local taxpayers want better services for their communities, they must be willing to pay for them, or if they want lower taxes they must be willing to accept the consequences for local services. Local sales taxes cannot serve this purpose, particularly as they relate to municipal government, because essentially they are a form of state revenue sharing—their rate is set in Raleigh and revenues come to local governments in the form of a check from Raleigh, not from local taxpayers—and because they do not fall substantially on all who enjoy the benefits of local services (such as owners of commercial office buildings).

If the property tax is to serve as a local tax, however, it cannot also serve as a state revenue source—that is, as a means of financing services that should be the responsibility of all the state’s taxpayers. If local governments are required to raise revenue to finance services and programs that need to be provided statewide according to some standard of uniformity (such as an adequate education program), the inevitable result will be disparities in the level of service and disparities in property tax burdens. Except for additional sales taxes that are distributed according to population (rather than point of collection), new revenue sources are not a solution to this problem because local units with poor tax bases will not benefit substantially from them. The need, then, is to define carefully what should be a state financial responsibility—what services should be provided without regard to the ability or willingness of local officials and taxpayers to support them—and what should be the responsibility of local governments in providing local services through local taxation.

FOOTNOTES

1 Article V, Sec. 2 (1) of the North Carolina Constitution.
2 These legal constraints are laid out in G.S. 153A-149 for counties and G.S. 160A-209 for municipalities.
4 G.S. 105-463-474.
5 G.S. 105-480-487 and G.S. 105-495-504.
6 Article V, Sec. 1 of the N.C. Constitution.
8 G.S. 153A-292(b) and G.S. 160A-314.1(a).
9 Public enterprise activities could include such services and amenities as airports, bus service, and off-street parking.
10 Chapter 591 of the 1991 Session Laws, now codified as G.S. 160A-314(b) and G.S. 153A-277(b).
11 G.S. 20-97.
12 Chapter 345 of the 1993 Session Laws.
13 Chapter 456 of the 1993 Session Laws.
14 G.S. 160A-613(b).
15 G.S. 158-42.
16 Article V, Sec. 1 of the N.C. Constitution.