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Comments on the "Report of the Commission on State and Local Revenues and Expenditures and Related Matters"

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Mr. Atkeson, Mr. Arnold, ladies and gentlemen, fortunately for both of us I was invited only two days ago to come here, so I have not had an opportunity to write a speech. But I have been living with the problems of the Tax Study for 18 months, so though it is difficult to compress 18 months of thoughts into twenty minutes, my effort here will be to try to hit the major elements of the Tax Study Report. If I skip something that you want to hear about, as far as I am concerned, I should be pleased to try to answer any question you might have. I am a little overwhelmed by the eminence and expertise of your previous speaker, and I would like to make it clear at the beginning that I am neither a lawyer nor a tax expert; in the Virginia General Assembly you have to make a living and do all sorts of other things besides be a part-time legislator. So my remarks are general.

The first problem upon receiving a directive as broad as our Commission received from the 1962 Legislature is to define the work and settle on the areas that are both doable and significant. This is difficult: to pick basic elements rather than the elaborate compounds. Then, of course, one must quickly agree that there is no such thing as "an ideal tax system"; what you are trying to do is achieve the maximum degree of practical, workable good sense that the Legislature can reasonably be expected to take seriously. Then there is the messy problem of accumulating facts and picking the facts that count and then digesting them. In this, I think we did a reasonably good job.

As for the Report itself, it doesn't contain any magic at all. We tried to go ahead and face the tough problems, and there are one or two we described and to which we offered solutions—but which I should be amazed to see the General Assembly actually face up to. The Study's introduction tries to paint a picture of the general situation of State and local revenues and expenditures. It points out that our basic tax structure was established in the 1928 Constitutional amendments. Since that time Virginia—her population, her economics, her services—have changed greatly. There has been the migration from country to city, shifting, or at least unsettling, the balance of power; the change from an agricultural to an industrial economy; and the appearance of a vast new range of services that are expected of government. Add to these a huge population increase, increased costs, new standards of living, and all that, and it is quite remarkable that our tax system has accommodated all these changes as well as it has.

Our last consequential alteration in the system was a major increase in the income tax rate in 1948 which, incidentally, produced so much more money than we needed for State functions that we gave $75,000,000 to the localities to build schools with. It was a debatable thing in principle but, in my opinion, much needed to allow the State and local governments to meet their most vital commitment. Since that time both State income and State expenses have climbed steadily. But expenses have climbed more rapidly than income. These tendencies are shown on a graph in the report. And the graph shows how each time the expense line has almost caught up with the income line, we have deferred that meeting by one of a series of windfalls (accelerations and selected sales taxes totaling $164.7 million.) As the graph shows, just as these two lines almost hit, Mr. Morrissett comes up with a little magic and the revenue line takes a healthy jump; then the lines tend back toward each other and another dose of magic is required to avoid red ink. But even Mr. Morrissett, I believe, agrees that the little bag of tricks is almost empty and that we are heading toward the need for a major new source of revenue. As for local finances, there is the general cry that the localities are in difficulty and are some $600,000,000 in debt. When you talk to bond counselors, you find out that though some localities are less healthy than others, none have a dangerously high bond indebtedness. Nevertheless, $600,000,000 is a lot of money and the trend to greater indebtedness is too serious to be ignored. It is not safe to generalize about localities because of the extreme range of their economic and human resources. But this much of a generality can be made—the two types of localities that are in the toughest spot are the big urban centers where the need for services has generally outpaced the growth within the restricted boundaries and tax resources, and smaller rural counties where there has been a large exodus of human talent and a depressed one crop economy, or no real economy at all. These counties are in a very tough spot, and so is the politician who tries to do anything sensible about them. It is a plain fact that some of these localities are too small and too poor in economic and human resources to be expected to carry any reasonable degree of the costs of their most basic services. So this raises the question of the justification for them. It is ironical that the least self-sufficient localities are frequently the most devoted to dreams of sovereignty. This makes merger of units nearly impossible and a subject which the politician treats with great care and caution—or not at all. Nevertheless, we have 130 school superintendents now; we don't need that many, and we are going to have to face the music sooner or later and realize that at least the consolidation of some services is compelled in the interest of a degree of efficiency and economy. The same is true of our tax collecting and court systems.

We divided our work into three parts: state finances, local finances, and state grants-in-aid to localities, which link the first two. As to our approach to State finances, we proceeded on the basic conviction that was that if we could provide a generally fair and reasonably understandable tax climate, business and industry will respond by investing and growing and thereby producing the wealth and jobs that it takes to produce the taxes that it takes to pay the bills for State services. This, of course, is not a certainty, but it is a probability that I think all of us feel should be pursued. We found by specific and careful inquiry of competent, national business people that Virginia is generally regarded as a favorable tax state, except for half a dozen instances of disproportionately heavy tax treatment of particular segments of our industry. And our recommendations are that these be corrected. Briefly, here are the recommendations. One, prohibit localities from levying gross receipts tax on manufacturers. This is a general law but some exceptions have crept into a few city charters; manufacturers rightly consider this an unattractive threat. Two, prohibit localities from levying tax on machinery and tools in excess of $1 per hundred of actual value. In Richmond, for instance, it might look safer to raise needed additional revenue from the impersonal machinery in our tobacco plants than from homeowners who vote. This action would simply throw Virginia's cigarette industry to North Carolina and Kentucky. Three, levy only once on stored tobacco. Our inventory tax is levied once a year and tobacco is stored for two to three years; so the same tobacco is taxed two or three times. We think this has been a factor in the driving of some amount of cigarette manufacturing out of the State, and has kept Virginia from getting its share of increased production in recent years. Four, exclude money from the definition of capital not otherwise taxed. Taxing money is costly to us, causing money either to be put in Government notes at the year end or to be shipped out of Virginia to avoid the tax. A sizeable part of this money is not brought back and this is a serious loss of the life blood of Virginia commerce. Five, reduce the tax on other capital from 65¢ to 60¢ to 55¢ to 50¢ in annual steps. There is good reason to move to 50¢ right now, but we could not disregard the practicalities of balancing the budget without enacting a sales tax or a major increase in income tax. Six, reduce the wholesale license tax. Like the tobacco tax, we can pretty well prove our present non-competitive rate is costing us money.

We think that if we make the recommended corrections, it will prove a sound investment for the accelerated growth of Virginia's economy. In recent years personal income growth rate has been about 5%. If these changes should accelerate that growth to a rate of 6½%, it is possible that for the next several biennia we could meet our expenses without a major increase in taxes. That is the general philosophy behind our recommendations concerning State taxes.

Now, the local finances—there is great respect in Virginia on grounds of both principle and sentiment for keeping government close to the people and respecting local autonomy. Our recommendations on local taxes in effect give the localities a better opportunity to practice what they preach. It will be interesting to see what comes of it. The cities now have certain taxing powers which counties do not have. We recommend giving counties those powers, the more valuable of which are the utility consumer tax and general licensing powers. Also, we propose a formula for the treatment of personal property tax on household goods and personal effects which would, in localities choosing to tax these subjects, promote equal treatment of all taxpayers in the locality and incidentally produce more revenue. The taxpayer would have the option of reporting his household goods and personal effects at 10% of the assessed value of his house or listing and assessing the whole works and being able to justify it. They have done this in Roanoke and Lynchburg; it has stopped a lot of fussing about this tax on the grounds that one man reports honestly and another does it dishonestly, and it produces more revenue.

Our next area of concern was the correction of certain deficiences in local assessing processes. I was chairman of the Committee on Local Revenues and Expenditures and it fell my lot to treat this subject. It is really astonishing how sloppy (I don't really mean that word disagreeably; it is just a fact) the assessing process is in many areas, particularly the smaller rural localities. The assessing responsibility is in the hands of the local government. The Report describes how these are and are not met. Maryland and West Virginia, after all sorts of difficulties, have largely removed assessment authority from local to centralized state authority. We could centralize the whole process in Richmond; it might become necessary some day. But it would conflict with our philosophy of local government, so we think it is reasonable first to try to encourage the localities by extending the greater technical help it takes to do a good job and to keep a little heat on them to do this job. I think only 53 of the 91 counties now have up-to-date property maps and inventories of real estate. What this means is that a great deal of real estate is not properly listed and therefore not properly taxed or not taxed at all. In the case of machinery and tools and timber and minerals, many a conscientious assessor or comissioner of the revenue wants to do this job but simply does not have the technical know-how; so, for example, you have a large timber area in one county assessed one way in an adjoining county another way. This is not a matter of dishonesty or gross negligence, but simply a lack of know-how required for an increasingly technical job.

The third section of the Report is concerned with restoring equality in local real estate tax burden, now almost prevented by the 40% uniform statewide assessment of public service property. This is a complicated subject, and I dare say that any real and constructive solution will constitute one of the least popular things anybody could bring to the Legislature. The localities assess their non-utility property, not at fair market value as required by the Constitution, but at varying fractions of fair market value. The Corporation Commission appraises public service property at a uniform 40% of cost, less not more than 20% depreciation; cost less limited depreciation being the best approach to value of public service property since this is the basis of rates. The 40% ratio was fixed years ago to equalize the treatment of utility and non-utility property. The effect of the present system is to enable and encourage a locality with a massive public utility installation simply to use the utility as a device through which to pass the cost of its government on to its neighbors. Now I will attempt to show you how this works. These are actual cases but I won't name them—there is no use in going into that.

	X	*Y*
Assessment Ratio	9.2%	22.4%
Nominal Tax Rate	$4.70	$4.00
True Tax Rate	.43	.90
Real Estate-True Value	66,862,000	27,614,000
Public Service-True Value	7,329,000	2,365,000
Real Estate Value subject to Local Tax	6,151,000	6,189,000
Public Service Value subject to Local Tax	2,932,000	946,000
Local Tax on Real Estate	289,000	248,000
Local Tax on Public Service	138,000	38,000
Local per ADA Real Estate Tax	$55.75	$109.20

County X has an assessment ratio of 9.2%, a nominal tax rate of $4.70, a true tax rate of 43¢. County Y has 22.4% ratio (which though low is considerably more than X's) a $4 tax rate, and a 90¢ true tax rate. So you see the true tax rate in one of these two similar and adjoining counties is twice that of the other. How is this possible? The non-utility property values are $66.8 million in County X and $27.6 million in County Y. The public service value in County X is $7.3 million and $2.3 million in County Y. In both cases values in X are three times what they are in Y. X is bigger and X has a utility generating plant. Now what happens is that when you apply the 9.2% ratio to the $66.8, you immediately reduce your local property tax base to $6.15 million. You apply 22% to Y's values which are only a third of X's and you come up with almost exactly the same local tax base. So all of a sudden County X and County Y each have the same local tax base as far as locally taxable non-utility property is concerned. How can X afford this reduction of its tax base? Well, X simply applies the uniform 40% to the public service values and comes up with a public service base $2.9 million. This is fine for X, but not so fine for Y who comes up with a public service base of only $900,000. The consequence is that though X has three times the local property values of Y, the citizens of X put up no more taxes than those of Y. This is possible because County X gets $138,000 out of the public utility property and County Y only gets $38,000. Farmer Jones on this side of the border pays $100 taxes on his farm; Farmer Brown on the other side pays $50. Now I don't think these two farmers know what is going on or there would have been a little hell raised about it before now. I am not supposed to be a missionary or reformer, but I see it my job to state and describe what I consider to be the most serious and fundamental flaw in our whole tax system. I noticed one of the dissents in the Report says that, in effect, "why on earth do you want to give this tax relief to these big fat utilities?" Well, it is my conviction that public utilities don't pay taxes—they simply transmit them—through the rate structure to consumers in the area who are supposed to be getting equal service at equal cost. And there is a big difference between a manufacturing plant that a locality solicits and to whose employees it must furnish expensive services and a state franchised and regulated monopoly. The purpose and justification of the monopoly is defied when through the monopoly you are able to pay half the taxes I pay. I don't mean to get too vehement about this. The city boys will think what we say makes good sense because some of us are abused pretty badly by the present system. And the country boy will think it's ridiculous, especially if utility taxes are running his government. I don't expect to see us deal with the problem, but I really do not comprehend why County Y lets itself get took so flagrantly by County X.

The inequities will increase because public service companies will continue to centralize their installations and grow faster than the general economy. The Assembly's neglect of this problem, and the blueprint offered in this Report, will practically command every Board of Supervisors to lower the local ratio forthwith. They might even be charged with neglect of duty if they do not, and their only excuse will be to show that they have no public utility through which to soak their neighbors. In my opinion the trend will continue until the thing gets to be such a mess that there will be a Constitutional amendment that will make public service property a subject of State taxation; the State will collect the money and distribute it back to the localities on some mystical formula. I do not have time to outline the solution we propose. I believe it is sound and practical, and I should dearly love to see the Legislature give it serious attention.

If we actually face this problem, and extend to counties the taxing powers they are now denied, and try to help them spruce up their assessing processes, we will see for the first time fairly accurately the actual extent of the localities' need for further financial help from the State. There are a number of localities that are making a very high effort with meager resources, and there are others with considerable resources making a miserable effort to carry their own weight. We will find out which localities really need help and we will have reassured the taxpayer of one locality that he is being treated equitably in relation to the taxpayer of another. And even more important, if and when we enact a sales tax, we will have a sound and firm and reasonable foundation on which to apply the new money. This is terribly important, I think.

In the third section we deal in the grants-in-aid. 60 of the 91 counties received more than 50% of their total revenues through State grants. So the State has a big stake in the financing of local government and a big responsibility. Of course, public education is the biggest cost and biggest responsibility of all. Last year the State's basic appropriation for teachers' salaries was $136 million and the supplemental minimum education appropriation was $56.3 million. There are several bad faults in the present method of school distribution and the salary scale, I believe, is too rigid for the individual needs and capacities of these various localities. The definition of need is unrealistic—Falls Church, for instance, spent $548 a year per pupil and Buchanan spends $171, so when you enter $255 representing the average need, you are very likely to give someone too much and someone too little. The measurement of local ability is unsound; this year school money was distributed on the basis of 1956 true values rather than 1962 true values and the consequence was that the State picked up about $32 million of minimum education costs more than it would have if the proper entries had been put into the formula. The relation between the basic appropriation and the minimum education fund is faulty in sort of a technical way not anticipated when the formula was adopted. We have tried to correct all these faults and come up with one simple formula. The basic element of this formula is: if the locality will put up $300 to educate a child, the State will reimburse $200 to the locality, emphasizing what you actually put up rather than any of the rather fuzzy and nebulous measurements of local ability. This just says you put up this much, and once you lay it right on the table, we give you back ⅔ of what you put up. And what is going to happen, of course, is that this plan and the State Department of Education plan, which is different in some important respects, will be negotiated into something different and, I hope, better.

The next section in the Report deals with new sources of revenue. We tried to project the State's General Fund income and General Fund expenses for the next three biennia. To go any further is unrealistic; it is so hard to anticipate. Then we set out the cost of tax relief, or losses of State revenue, that we recommended. This shows a small deficit between revenues and expenditures. We avoid pinpointing a particular tax that we think ought to be enacted to correct this small indicated deficit. I don't know whether or not you call $11 million small, but it is relatively small and could be substantially reduced by the reappraisal of the usually overly conservative estimates of surplus by Mr. Morrissett. But do not get excited about the surplus; we have this large surplus mainly because of the enactment of the withholding tax, and it is not something that you can rely on forever. We show expected expenses and expected revenues and we list and analyse briefly all the tax sources which might be enacted to fill the gap.

In the Report's concluding section we observe that the State tax structure is generally sound with the exceptions which I have mentioned. But, in spite of the surplus, we believe that we will need some new money, and you can expect some sort of adjustment of your taxes to provide this new money. We state that broader revision such as reducing the retail license to a privilege tax rather than a major revenue producer would certainly require a sales tax or a major increase in income tax. We reemphasize the principal problems involving local finances of the school money formula and the public service taxation, and the matter of compelling or encouraging localities that are making a substandard effort to come up to a reasonable plateau. We emphasize the significance of industrial growth as a generator of wealth not only for the locality but for the State, which needs constantly more tax revenues to meet ever increasing demands more and better State services. We raise the question of whether or not it makes sense to organize a lay commission of people like myself who are trying to do other things and not specialists, to make a review of this type in 18 months. It takes half that time to assemble the facts and figures, and a lot more time to digest them and get some real understanding of the State's finances or of a complex subject like public utility taxes. So we suggest that there might well be created something we might call a permanent tax policy commission. None of us likes more bureaus and more offices, more files, more costs; on the other hand, if we could keep our statistics and studies up-to-date, we might have a better chance of keeping our adjustments up-to-date and of avoiding the agony of epochal change. This idea has drawbacks, but merits consideration. I have talked eight minutes longer than I was supposed to, and I apologize; I know you are tired and hungry. I thank you for letting me discuss our Report with you. None of us on the Commission are experts, and all will be eager to have your professional guidance as we try to pursue our recommendations in the General Assembly.

Dr. Atkeson:

Did someone have a question?

Yes, I very much wanted to ask this speaker if he would comment just a minute or two on the outcome of the sales tax.

Well, I don't think there is any secret about that. You have this $40 million surplus and with such a surplus it is of questionable political wisdom to go to the people and propose a major tax increase. That might seem just a little too political an answer, but actually it is not. We think that the growth of the State's economy will come very close to meeting our expenses, and the Governor, I believe, is reluctant to ask for a sales tax. And I, myself, would not have too many qualms about a sales tax in principle, but I am terribly concerned about what happens to the sales tax money. As it is now, if ten men in the Legislature are for the sales tax, eight of them are for it because they want money to be raised by the State and sent back unearmarked to the localities. And unless you insist that the locality carry a reasonable share of its own load, the money will go back to County X, and they will immediately lower their real estate assessment. The State has increasingly expensive responsibilities—to itself and to its subdivisions. The State must be certain that its last remaining untapped source of money is rigidly directed to meet these responsibilities. For the State to subsidize the negligence of some subdivisions would be distressing indeed to other subdivisions and to the people of Virginia. Until we have full understanding on these matters, I should hate to see a sales tax bill pass the Assembly. I am sorry to give you such a long answer but that is the way I see it.