

July 2009

Why Should You Care About the Index of Taxpaying Ability?

Holley H. Ulbrich and Ellen W. Saltzman

WHAT IS THE INDEX OF TAXPAYING ABILITY?

The index of taxpaying ability is a very important number. The index, or ITA for short, is the main tool used in South Carolina to partly equalize education funding across school districts. It is used to determine what share of education costs in each district is paid by the state, and how much has to be raised locally by that district. A district with a high index has to rely more on local funding, while a low index entitles a district to more state aid.

The primary source of state funding for general school operations is the Education Finance Act (EFA). The ITA was created by the EFA. The EFA isn't the only source of state funding for school districts, but it does account for about 22 percent of total school operating revenues. Other state funds are distributed using the same formula, mainly for employee benefits and transportation, so the total share of operating funds affected by the EFA formula is about 30 percent.

The EFA provides for shared state and local education funding based on the number of pupils multiplied by the base student cost. The base student cost is the amount of money needed to achieve minimum standards in a basic elementary and secondary education program. Set in 1977, it has been adjusted for inflation since then in most years.

The EFA base student cost is set by the General Assembly each year. For 2008-09, base student cost was originally set at \$2,578 per pupil, but was later cut to \$2,190. The number of pupils is adjusted using weights that reflect grade, special needs, and other factors. So for a district with 5,000 (weighted) pupils, the total EFA part of education funding in 2008-09 would have been:

For the average school district, the state pays 70 percent of total EFA funding, while the local school district must raise the remaining 30 percent from property taxes. Some districts get more than 70 percent of their EFA formula funding from the state, while others get less. The share for a particular district is determined by its index of taxpaying ability.

The ITA is simply the assessed value of taxable property in the district divided by total assessed value of taxable property in the state. In other words, the index tells us what percentage of the total taxable property in the state is in this particular district. The larger the district's tax base, the larger the district's ITA, and the more local property tax revenue the district can afford to raise toward the total cost of education. Districts with very small tax bases have small ITAs and aren't expected to raise as much revenue.

So the ITA is pretty important, because it's the main tool for redistributing revenue from richer districts to poorer districts in order to level the education playing field. It's not perfect. The state still sees lower mill (property tax) rates¹ in richer districts than in poorer districts for the most part. But at least the ITA does some equalizing among districts.

WHAT IS WRONG WITH THE ITA?

When EFA was enacted in 1977, the index of taxpaying ability was a reasonable way to assign local responsibility for helping to pay for education. Unfortunately, the ITA has run into some problems in the last two decades. The first problem came from fee in lieu of tax agreements, or FILOT, which counties can negotiate with new and expanding business firms that create jobs. FILOT agreements were introduced in the 1990s.

Instead of paying property taxes, firms with FILOT agreements pay a fee that is negotiated with the county, including a share for school districts. These properties were generating school revenue, but the revenue they produced didn't change when the mill rate changed. Somehow FILOT agreements had to be reflected in the ITA. Otherwise, the ITA would be understating the revenue capacity of districts with FILOT property.

The South Carolina Department of Revenue solved that problem by adding something to the property tax base to reflect the revenue generated from FILOT property. The figure added was the assessed value that FILOT property would have to have in order to generate that much revenue.

Suppose, for example, that a firm was paying a fee of \$100,000 a year. The Department of Revenue treated that figure as the property tax payment for that property. Suppose, further, that the mill rate in that district for school operations was 80 mills, or \$80 per \$1,000 in assessed value. The DOR would calculate the assessed value of the property generating the fee as follows:

$$\text{Property tax (FILOT) revenue} = \text{Assessed property value} \times \left(\frac{\text{Mills}}{1,000} \right)$$

¹ The mill rate is the tax as percentage of the property's value, but expressed in thousandths rather than hundredths. A mill rate of 125 mills would mean a tax of \$125 on an assessed value of \$1,000. Most school districts have two mill rates, one for operations and one for debt service.

Or restated:

$$\text{Assessed property value} = \frac{\text{Property tax (FILOT) revenue}}{\left(\frac{\text{Mills}}{1,000}\right)}$$

In this case:

$$\text{Assessed property value} = \frac{\$100,000}{.08} = \$1,250,000$$

So \$1.25 million would have been added to the value of taxable property that is used to compute the ITA in that school district and in the state.

A much larger problem with the ITA came about as a result of Act 388, passed in 2006. This legislation abolished school operating taxes on homeowner property and replaced it with property tax relief payments from the state, funded by sales taxes. After the first year, the value of state property tax relief payments is no longer related to the value of homeowner property. Instead, it depends only on inflation and population growth statewide, and on student population growth in a particular district.

So building additional homes—or increases in the value of existing homes—doesn't increase the property tax revenue (including property tax relief) of a school district. But the property is still in the tax base, because the owner still has to pay city and county property taxes as well as taxes to repay school bonds (debt service). A district might have a high ITA, but a lot of the property in that index might be homeowner property that doesn't represent the district's ability to generate more school operating taxes. So the ITA would overstate the district's ability to raise additional revenue. The opposite would be true of a district with a smaller share of homeowner property.

WHAT SHOULD BE DONE?

Why not just take owner-occupied property out of the ITA? That sounds too easy, and it is. The percentage of property that is owner-occupied varies greatly from district to district, from a low of about nine percent to a high of about 42 percent.

A district with a lot of owner-occupied property will be getting a higher initial property tax relief payment from the state, although that payment grows slowly after the first year. But if the district has to increase the mill rate, that homeowner property won't generate any more tax revenue. A district with a very low percentage of property tax in owner-occupied homes doesn't get much property tax relief from the state, but when it raises the mill rate, that district will see more of an increase in revenue.

So the ITA no longer measures local ability to pay, for two reasons. First, the ITA doesn't take into account the district's property tax relief payments from the state. Second, the ITA doesn't reflect the fact that part of the district's tax base doesn't generate more property revenue when the mill rate is increased, and that the share varies greatly from district to district.

A short term fix can be made to the index ITA by adjusting it in the same way that the Department of Revenue did for FILOT payments. If a particular district is getting \$4 million in property tax relief payments, what would be the assessed value of owner-occupied residential property that generated that much revenue? Again, it depends on the mill rate. A tax rate of 80 mills would have generated \$4 million in revenue from property worth \$50 million in assessed value before Act 388:

$$\text{Assessed property value} = \frac{\text{Revenue (tax relief payments)}}{\left(\frac{\text{Mills}}{1,000}\right)}$$

$$\text{Assessed property value} = \frac{\$4,000,000}{.08} = \$50,000,000$$

So \$50 million in owner-occupied residential property would be counted in the property tax base of the school district and the state in place of the actual assessed value of homeowner property.

In the long run, the state of South Carolina will need a better and simpler measure of the ability of a local school district to contribute to the total cost of education. But fixing the index of taxpaying ability to correct for the effects of Act 388 would be a good place to begin.

Holley H. Ulbrich is Alumni Professor Emerita of Economics at Clemson University and Senior Fellow of the Strom Thurmond Institute. Ellen W. Saltzman is a research associate at the institute. Both have written extensively about tax policy and government finances in South Carolina.



Strom Thurmond Institute of Government and Public Affairs
Pearman Boulevard
Clemson University
Clemson SC 20634-0125
864.656.4700
www.strom.clemson.edu

The views presented here are not necessarily those of the Strom Thurmond Institute of Government and Public Affairs or of Clemson University. The Institute sponsors research and public service programs to enhance civic awareness of public policy issues and improve the quality of national, state, and local government. The Institute, a public service activity of Clemson University, is a nonprofit, nonpartisan, tax-exempt public policy research organization.