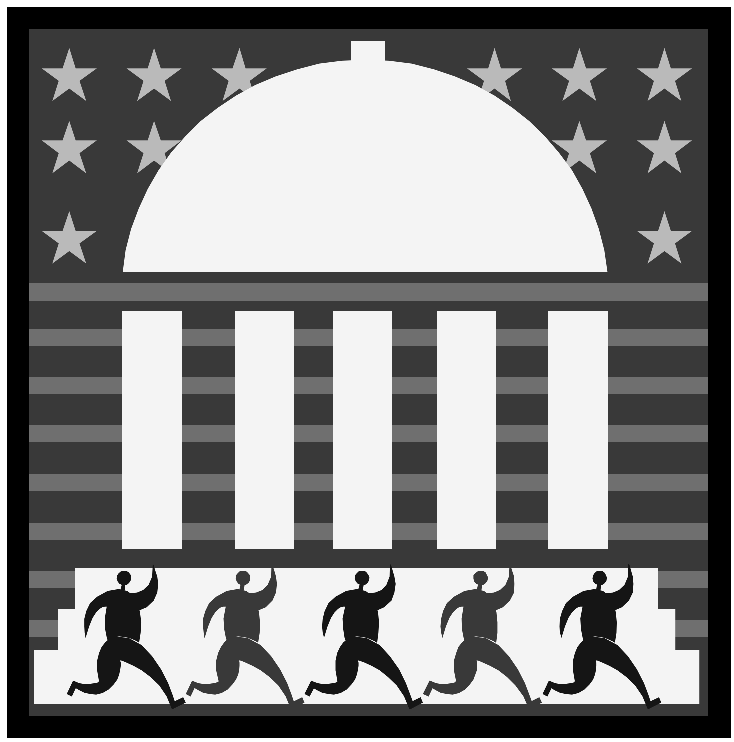
A Summary of the Study

County Finances:

Tax and Revenue Systems in Washington Counties



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Introduction

The county finance study was written by the League of Women Voters of Washington (LWVWA) in partnership with the Institute for Washington's Future (IWF).

There is a need for greater understanding of taxes in our communities. Both the LWVWA and the IWF believe that we should lead our communities in discussing how our governments should be financed. We hope that this study will help our members take an active role in informed public dialogue.

Why did the League of Women Voters of Washington and the Institute for Washington's Future (two state level organizations) study county finances? There are several reasons.

- Counties have increasing state and regional responsibilities and have been affected by several changes in the tax system recently, including Referendum 47 and Initiative 695.
- The authority for counties to tax comes from the state legislature and any changes in the finance system must come at that level.
- Increasing pressure of growth has affected county government more than any other.

One thing is very clear: the complex relationships of taxes in Washington State are difficult to understand. Our goal in publishing this study is to investigate the intricate web of intersecting state and local taxes and find the issues of importance to our county finance system.

Government Finance

The concept of government finance is basically simple. It is the collection, allocation and disbursement of funds to provide public benefits and achieve the common good. But the system itself must be consistent with the common good. This means the financial system should be:

Fair. Fairness means that the burden of payment should not fall unequally on taxpayers when the ability to pay is taken into consideration.
Adequate. A tax system must raise enough money in bad times and good times to cover the services requested by the citizens.
Balanced. Tax revenues should be obtained from a variety of sources to help achieve fairness and stable revenue.
Flexible. A flexible system does not have too many restrictions. It can meet the strains brought on by increases in population, fluctuating job rates and changes in society.
Manageable. The tax system should be easily understood by the taxpayer, should encourage voluntary compliance and be easily administered by the taxing authority.
Economically Sound. The tax system should not cause business to be at a competitive disadvantage with similar businesses located elsewhere.
Safeguarded. The system should contain proper safeguards and limits to raising money without taxpayers' approval with government accountable for the spending of all revenues.
Non-burdensome. A tax system should not take more money from the taxpayer than he can afford.

These criteria strongly emphasize the payment of taxes: who should pay, what should be paid and how it should be paid. They go to the heart of the impact of taxes on the individual citizen in demanding fairness, balance, economic soundness and the absence of unbearable costs. On the other hand, these criteria emphasize the need to make allocation and disbursement effective so that government can function properly. The financial system should establish appropriate levels in which government should operate. It must produce sufficient funding to insure basic needs are always met and provide limits that prevent the government from overrunning the capacity of the public to pay.

Washington State Finance System

The state of Washington controls, through its Constitution and the Legislature, the tax and revenue systems of the state and of local governments, including counties. Taxes are interwoven among state, county, city, and special district, as are the responsibilities that they pay for. The system of taxes is complex and involves over fifty different taxes. State taxes account for an unusually high 69% of total state and local taxes in our state, while local taxes account for the remaining 31%. This is due to the fact that services such as education and public assistance are provided at the state level. The state relies on sales and use taxes. Property taxes play an important role in state and county finances and can vary due to voter-approved special levies. Owners of real and personal property pay property taxes annually based on the assessed or fair market value. The state collects all taxes on behalf of all jurisdictions, with the exception of property taxes. The counties collect property taxes. Most of the property taxes go to schools. There are many limits placed on the raising and spending of taxes at the state and local level. These limits have been placed by the people through their representatives and through initiative.

County Government: Purpose and Responsibilities

County government is a microcosm of American government in general. This is true not only because it stands at a central point in our governmental system, but also because it is the one form of government that has day to day contact with citizens in rural, suburban and highly urban areas. County government is a good place to start in understanding government and its many elements, including understanding government finance.

Counties have three levels of responsibilities: as a state agent, as a regional government, and as a local government. Counties act on behalf of the state to provide criminal justice, conduct elections, and maintain records and licenses, among other duties. Counties act as regional governments in providing transportation, housing, growth management planning, waste management, and public health. Counties must provide local government services to unincorporated areas. The services provided by counties are determined by the constitution, the state and by local residents. In addition, county government has added services and regulations not contemplated by the constitution, to respond to citizens' needs for everything from social services to sophisticated health and environmental protection. These changes have generated the need for cooperation among governments, where federal funding meets local or regional programs. More often than not, county government plays the leading role in forming these relationships. The state does not provide full funding for the services that they require of the counties. This situation is often called unfunded mandates. The state has authorized more local options for taxes for local governments to raise funds. There are more and more demands for government services and there is less and less revenue available.

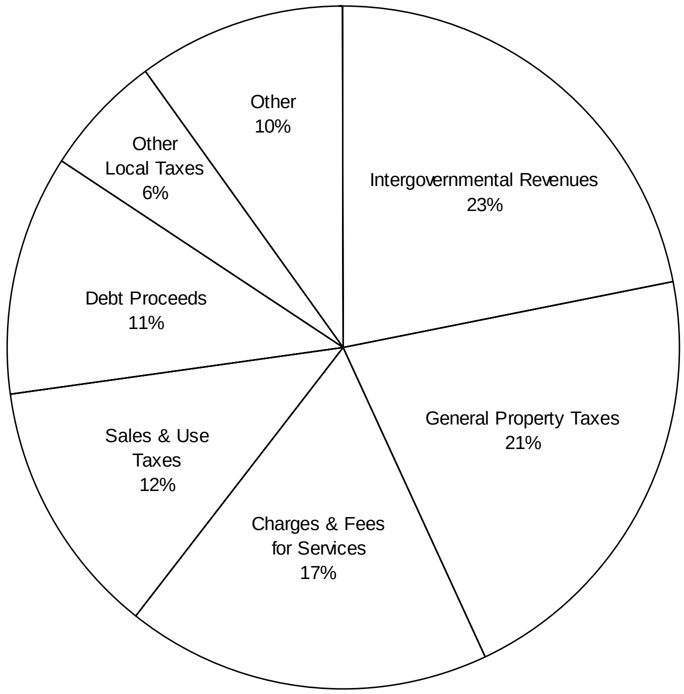
How County Finances Operate: Revenues and Expenditures

Revenues

Counties raise the money they need to provide services from a number—sometimes hundreds—of sources. Revenues coming from some sources, such as the federal or state government, must be spent for a specific program or service. In these cases the state or federal government mandates how the money must be used. In other cases, counties can determine how to spend revenues. This is referred to as discretionary money.

The following chart summarizes total county revenues by funding source for 1998.

1998 Revenues for All Counties



(Other includes the following: Interest and Investment earnings; Rents, Insurance Premiums, Internal, Contributions, Misc; Fines and Forfeits; and Licenses and Permits)

As this summary makes clear, the most important source of revenue for Washington counties is revenue from other governments (intergovernmental), primarily federal and state, followed closely by property taxes and fees for services. Sixty percent of county revenues come from non-tax sources—such as intergovernmental revenues, licenses and permits, and fees for services. For example, counties receive direct grants from the federal government for housing, health and human services; they charge fees for marriage licenses and building permits; and they receive fees for parks and sheriff services.

Revenue from taxes directly levied by county government constitutes the remaining 40% of county revenues. This is what citizens provide so the county can achieve its core purposes and act to meet emerging concerns. Taxes are levied by applying a determined rate to the tax base, or the things being taxed (such as property, cigarettes etc.) These revenues are derived from a tax base that is directly controlled by county government and county voters, but limited by the state and voters statewide. This tax base is composed of the property tax, sales tax, and other local taxes on tourism, entertainment, timber and real estate transactions. Of these three tax sources, the property tax is by far the most important and most widely relied on by all counties.

The property tax is a tax paid by homeowners and businesses, based on assessed valuation of their property by the county assessor. Counties having higher property values are said to have a richer tax base, meaning they have the capacity to raise more money from property taxes than counties with lesser-valued land (poor tax base). Property tax levy rates are expressed in terms of dollars per $1000 of assessed value. Property taxes are subject to a constitutional limit of 1% of the value of the property. While certain property taxes are exempt from this limit, in general it has effectively capped property taxes in Washington.

Sales and use taxes are the second largest tax source for counties (and the fourth largest revenue producer). The state levies a sales tax of 6.5%. Local governments have various options to levy sales taxes up to 2.4%. All local governments use at least 0.5% of their options. None use the full 2.4%, although King county uses 2.1%. Additional use of the sales tax requires the approval of the state legislature.

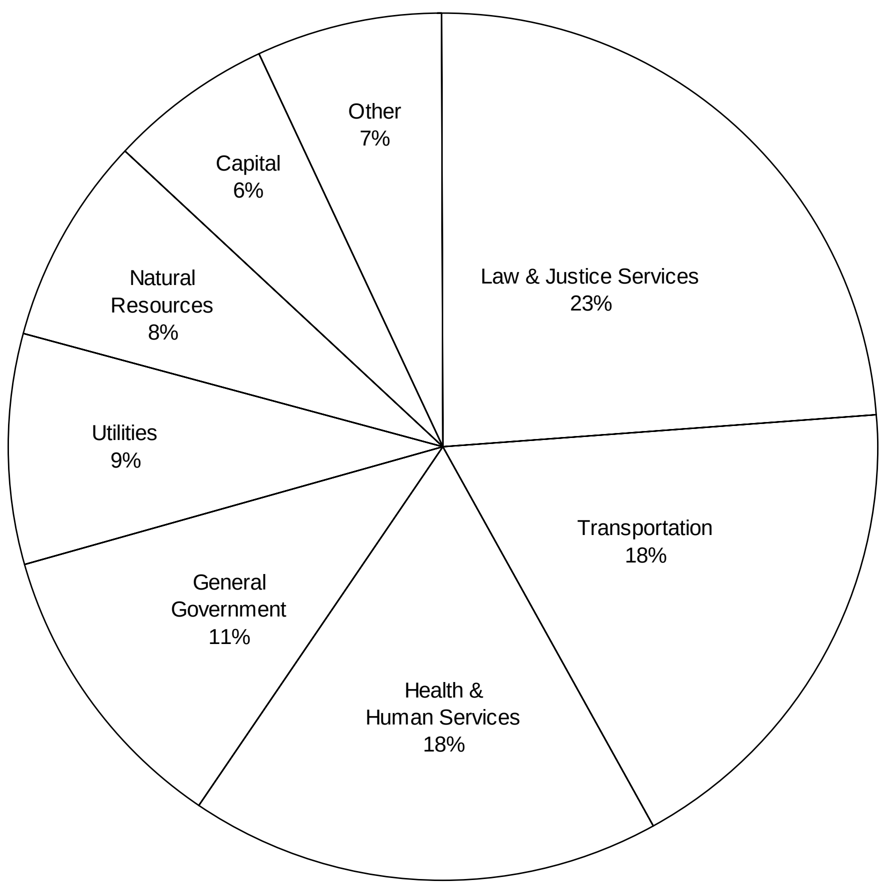
Taxes and revenues are complicated by the many overlapping relationships among the approximately 1400 special districts, 280 cities and towns, and 39 counties

Expenditures

Counties spend money to meet their responsibilities as set out by state law, and to meet the demands of their residents. They are required to track the money they spend very carefully. They use a system of funds to specify how money is spent and account for all expenditures. Counties can have numerous special funds—funds designated for specific services, often by the state or federal government. For example, Snohomish County has thirty-six special fund accounts, earmarked for an array of programs from children's services and mental health to river management and boating safety. County general funds contain funds that can be used for a variety of purposes as determined by the county. While the county has discretion over this money, all expenditures from this fund must compete with each other for limited money. In addition, counties must use general funds to make up any funding shortfalls for programs mandated by state or federal government.

How do counties spend money? As the chart below show, the three areas where counties spend the most money are law and justice, transportation, and health and human services. These three areas combined make up 60% of all county expenditures, with criminal justice accounting for about 24%. Other expenditures are for fire and emergency services, utilities, and natural resources. Money must also be spent for the actual running of government departments.

1998 Expenditures for All Counties



(Other includes the following: Fire and Emergency Services; Debt Service Interest; and all other expenditures)

Comparisons and Contrasts among Counties

The numbers for revenues and expenditures in the counties of Washington show many disparities. Many counties do not have much taxable property or retail centers that produce sales and use taxes. Yet these counties must provide a basic level of services to their citizens.

The 1998 sales and use tax collections in King, Pierce and Snohomish counties were almost three times the collection of that tax in all other 36 counties combined.

While not as steep, there is a similar disparity in the capacity of counties outside of Central Puget Sound to raise property taxes. King County alone has over 38% of the state's taxable property. If property tax rates were not higher in property-poor counties, the property tax revenue disparities would be much closer to those of the sales and use tax. As the chart below indicates, the end result is a stunning difference even in the relative tax capacities of counties.

Issues Raised

How do Washington's counties measure up to the finance criteria outlined earlier? The overlapping structure of local government, with its shared revenue and decision-making powers, combined with counties' reliance on property and sales taxes, produce disparities in tax capacity, changing boundaries and unfunded mandates. All of these contribute significantly to the productivity level of the local tax system and the ability of counties to serve the common good. These factors call into question the fairness, adequacy and balance of our county finance system.

Reliance on Property and Sales Taxes

The reliance on property and sales taxes produces great revenue disparities among Washington's counties and exposes the finance system to shortfalls during economic downturns. The burden of these disparities falls unequally on poor counties (most often rural) and lower-income families. Counties with shrinking tax base—due to property tax exemptions or low property values—must increase the property tax rate to maintain their revenue levels. This results in lower-income families paying higher tax rates than many middle- and upper-class families.

In economic boom times our tax system, like any other, produces surpluses. But, our tax system is highly dependent on consumption because of our reliance on sales taxes. The rate of consumption shifts more quickly and more dramatically in response to economic ups and downs. The other side of our higher surpluses is deeper, more precipitous shortfalls. This effect is magnified for county government by the importance of fees and licenses, sources also related to consumption. Continuing tax cuts and shifts during good times reduces our capacity to weather the inevitable bad times a system such as ours will produce.

Disparities

As illustrated by the chart above, county tax capacities vary significantly, often along urban-rural lines. Counties raising little revenue per capita encounter difficulty in meeting the needs of their residents. Insufficient tax base leads to a reduction of services, which in turn leads people to leave the area, further reducing the tax base. These disparities fall squarely on taxpayers. For example, property tax rates were highest—$16.90 per $1,000 of value in 1999—in Garfield County, one of the poorest property counties in the state. This is more than double the lowest rate—$8.10 per $1,000 of value, 1999—in San Juan County, one of the richest property counties in the state. Someone owning a $120,000 home in Garfield County pays twice as much in property taxes than someone owning a home of the same value in San Juan County. This is because poorer counties need a higher rate to produce enough revenue from that base to meet the county's needs.

Moreover, it is likely that individual taxpayers of the tax-poor county get less benefit for their tax dollar despite high tax rates. This is true for two reasons: First, it is much more likely that a taxpayer shops outside of his county. When and where that is true, the tax revenue and the benefit it buys is lost to the traveling taxpayer. Second, tax-poor counties cannot generate enough additional revenue to pay for more and better service. What little discretionary funds they can capture characteristically fall short of the threshold payments required to enhance services. The taxpayers in tax-poor counties are in the same position as someone who might be able to afford a little more than Wal-Mart prices but can't really afford Sears prices, and falls far short of affording Nordstrom's.

Changing Boundaries

Changing county boundaries through incorporation and annexation has severely impacted the capacity of urban counties to pay for themselves. As a rule boundary changes take place in and around areas with relatively high tax capacity. They are movements by such high capacity areas to gain more and better governmental services than can be provided by the county. These movements always reduce the tax capacity of the county in absolute terms: counties receive every dollar of sales tax that is collected in their unincorporated areas, but only $.15 of every sales tax dollar collected in their incorporated areas. They almost always reduce the capacity in relative terms—there is less tax base per capita and/or less tax base per unit costs. In real terms, urban counties find their sheriffs patrolling the back roads, their health and social workers driving long hours to meet isolated clients and the sales taxes from another major shopping mall diverted into somebody else's coffers.

Unfunded Mandates

Unfunded mandates, or much more often underfunded mandates, are a by-product of shared government. In the shifting of costs down the governmental chain, the funds to carry out new responsibilities do not always follow. This phenomenon hits local government—especially counties—the hardest. This is a liability both of being a constitutional sub-area and being at the end of the chain, where there is no entity left on which to pass responsibility. Mandates from above have substantially changed the cost structure of county government. The best example is the fastest growing and now largest cost center for county government—the criminal justice system. Mandatory sentencing policies adopted by this state have come with little additional funding. Yet they have generated clogged courts and crowded jails, and required responses ranging from building new jails to increasing the number of superior courts. These expenses have absorbed county revenues and forced counties to reduce allocations to other services. For those counties with little room in their budgets to begin with, coping with mandatory sentencing has been especially hard. Because unfunded or underfunded mandates are a concept open to varying interpretations, its impacts are hard to assess with precision.

Are There Solutions?

The tax system in Washington has evolved greatly over the lifetime of the state. The state started with a property tax and that property tax is still the foundation of local governments. In 1935, the legislature found that property taxes were inadequate and passed a whole package of new taxes including the sales and use tax, the business and occupations tax, and selective sales taxes. The state government is now dependent on the sales tax. There have been a multitude of changes and restrictions on taxes although the authority to impose taxes still rests with the state. Home rule counties do not have additional tax authority.

The finance system is complex and fragmented. It involves the state passing federal money on to local governments and local governments receiving money directly from the federal government. Both types must be spent on specific projects. It involves fees and permits that pay for services. It involves some discretionary spending on the part of counties. There are over 50 different state-authorized sources of revenue for counties, most of which produce very limited income and can be used only for specific purposes. The system has become a patchwork: governments must work to find which money that can be used for which services.

Do the people of Washington know where the money goes? The complex system also has complex accountability requirements. There is a direct tie between fees, permits, and some specific taxes to services provided. The small county portions of the property tax collected (remember most goes to support schools) and sales tax collected form the basis of county general funds - money that can be spent based on local decisions, but also must make up for any shortfalls for state or federal mandates. This spending provides general support of the health, safety, and quality of life of the county and its residents.

Is the money used effectively? Our finance system does not promote effectiveness. The large number of local governments (counties, cities, and special districts) have sometimes conflicting interests and must compete for the same pot of money. Services overlap. The demand for services continues to increase. The pattern of growth in the state does not promote effective use of resources. The sprawl of population creates jurisdictions that are more difficult to serve than dense populations.

Other states and their counties must deal with most of the same issues that have been raised by this study. Finding the right mix that works means a sincere investigation of alternatives including income tax, a more flexible structure with fewer restrictions, tax-base sharing, and development of a more diverse economy. Another choice of what to do about the gap between program costs and funding is the option of deciding to live with fewer governmental services and less government-built infrastructure. In that situation, who lives with less? Washington is a prosperous state. We have the resources to put together an adequate and equitable tax system, and to ensure Washington is a livable state for <u>all</u> its residents.