Criteria for Judging the Impact of Decreasing School Property Taxes
About the Center

The Indiana Education Policy Center provides nonpartisan research, information, and communication on education issues to Indiana policymakers and educators to improve education in the state and nation.

The views expressed in the publication are those of the author(s) and do not necessarily represent the positions of the Indiana Education Policy Center or its funders.
Criteria for Judging the Impact of Decreasing School Property Taxes

Neil D. Theobald
Indiana Education Policy Center

January 2003
Policy Research Report #03-02

An earlier version of this report was previously published as: Theobald, N. D. (1999). Criteria for judging the impact of eliminating property taxes as a primary source of school revenue. In B. O. Brent (Ed.), The political economy of education (pp. 59-63). Rochester NY: University of Rochester.

AUTHORS' NOTE: I would like to thank Indiana University's Strategic Directions Initiative for its generous support of this research. The content of this chapter does not necessarily reflect the views of Indiana University.
Criteria for Judging the Impact of Decreasing School Property Taxes

This paper first briefly updates the status of Indiana's system for funding K-12 education. The first two sections address the strengths and weaknesses of the current funding system. The goal in these initial sections is to provide benchmarks for analyzing how changes in the sources of funding might impact K-12 education in the state. The third section considers the implications of decreasing the school property tax in Indiana. How might this change help ameliorate some of the weaknesses in the current formula? Equally important, what factors do state policymakers need to keep in mind when revising the state tax system in order that they retain the many strengths the current formula possesses.

Strengths of the Indiana School Funding System

In 1993, the General Assembly rewrote Indiana's school funding formula in order to provide more equal access to revenues among the state's 294 school corporations. While the new formula increased per-student revenue by about 10% in inflation-adjusted dollars between 1993 and 1999, a crucial issue when we consider a 10% real increase in revenue is who is receiving these additional funds.

As Table 1 shows, Indiana’s school funding formula demonstrates vertical equity, the unequal treatment of unequals. The table compares the funding received by two groups of students in the state – minority students and poor students (those students who qualify for a free or reduced lunch) – to their White and non-poor counterparts. On average, minority and poor students are being educated by school corporations that are receiving more money than are the corporations educating White and non-poor students. In terms of current school finance litigation, this is a very important finding.
Indiana’s school funding formula is also moving towards horizontal equity – the idea of treating equals equally. As Table 2 demonstrates, the largest share of the 10% revenue increase is going to the lowest revenue school corporations. These relatively poor corporations are receiving an annual average revenue increase that is double the 2.2% rate of inflation during this period. As you move to the right on Table 2 – towards the relatively wealthy school corporations – the rate of increase declines. The ability of the Indiana school funding formula to make the distribution of revenue across school
corporations more equal while the formula is simultaneously disequalizing revenue in favor of poor and minority students is a vital strength.

Prior to 1994, general fund property tax rates varied widely across school corporations in Indiana with high-rate corporations paying more than double the rate of low-rate corporations. This issue of taxpayer inequity lay at the heart of the lawsuit that challenged the constitutionality of the state's previous school funding system (*Lake Central et al. v. State of Indiana et al.*, 1987). As Table 3 shows, the post-1993 formula dramatically increases rates in very-low rate school corporations. As a result, property tax rates will be substantially more equal in 1999, especially on the bottom end.

*Weaknesses of the Indiana School Funding System*

The Indiana school funding formula has generated higher average general fund tax rates in each year from 1993 to 1999. In 1999, school corporations in Indiana levied general fund property tax rates that averaged $2.85 per $100 AV, a 9.1% increase since 1993. The median property tax rate, though, remained relatively unchanged from year to year, with the exception of 1996 when it jumped 4%. The reason for this disparity in the trends for the mean and median tax rates is that the huge rate increases in the low-rate corporations push up the average but have much less effect on the median. In addition,
for the 1997-99 biennium, it is important to recognize that nearly half of the 7 cent rate increase is created by the state’s assessment ratio adjustment factor and therefore is driven by local assessment practices that lie outside the school funding formula itself.

Criteria for Judging Impact of Decreasing School Property Tax

This section seeks to put forward for discussion a set of criteria that policymakers can use in assessing the impact of decreasing the school property tax and replacing these funds with an alternative revenue source – regardless whether it is a sales tax, an income tax, or some combination of the two.

Criteria 1: Will the alternative revenue source(s) provide all school corporations with sufficient revenue to achieve state educational goals?

<table>
<thead>
<tr>
<th>Findings About the Indiana School Funding Formula</th>
<th>Issues with Alternative Revenue Source(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The formula provides increasing per student revenue, with the 2002 per student revenue level being slightly above the national average.</td>
<td>Would income or sales taxes provide sufficient revenue to Indiana’s schools, especially during economic downturns?</td>
</tr>
<tr>
<td>While growth in state support slowed dramatically in the 2002-03 biennium, increases in local property taxes will allow regular education revenue to grow by $260 per pupil.</td>
<td>Can income and sales tax rates be changed in the short term to provide schools with flexible access to revenue?</td>
</tr>
<tr>
<td>Substitution of a sales tax for the property tax could be revenue-neutral to the state and to local school corporations, but it would substantially increase the federal income tax bill of Hoosiers because property taxes are deductible from federal income taxes, while sales taxes are not.</td>
<td>Will Hoosiers seek to compensate for their higher federal income tax bill by decreasing their support for state and local education taxes?</td>
</tr>
</tbody>
</table>

The first issue relates to how robust the sales or income tax is, with particular emphasis on its stability. The property tax is a very stable source of revenue — it produces a consistent revenue stream in good and bad economic times. One of the realities of school finance is that, in the short term at least, the demands for school
services do not fall with dips in the economy — in fact, they tend to increase. Thus, the stability of any proposed alternative is a crucial issue.

The second issue relates to the flexibility inherent in a decentralized property tax system. Property tax rates are set township by township and can be easily changed to address emerging financial needs. Income and sales tax rates are generally set at the state level and thus tend to be much more constant over time than are property tax rates.

The third issue relates to the ability of educators to disconnect the inevitable increase in federal income taxes due from the on-going needs of Indiana’s K-12 schools. The higher federal taxes that Hoosiers will pay if the state substitutes a sales tax for the property tax will not directly increase funding for Indiana’s schools. However, a move to compensate for higher federal taxes by decreasing state and local taxes could directly decrease funding for Indiana’s schools.

Criteria 2: Will the alternative revenue source(s) allocate responsibility for school funding equitably between the state and local school corporations?

<table>
<thead>
<tr>
<th>Findings About the Indiana School Funding Formula</th>
<th>Issues with Alternative Revenue Source(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>The formula provides a 2-to-1 state-to-local instructional revenue share.</td>
<td>Do traditions of local control require some minimum local share of school revenue?</td>
</tr>
</tbody>
</table>

The major issue with regard to Criteria 2 is the impact of any tax restructuring on traditional notions of local control of K-12 education by school boards elected by, and accountable to, local tax payers. Do these traditions require some minimum local involvement in financing these schools?
Criteria 3: Will the alternative revenue source(s) improve taxpayer equity?

<table>
<thead>
<tr>
<th>Findings About the Indiana School Funding Formula</th>
<th>Issues with Alternative Revenue Source(s)</th>
</tr>
</thead>
<tbody>
<tr>
<td>According to Papke (1998), Indiana’s tax system is more regressive than its neighboring states. Indiana’s current low reliance on the sales tax prevents the system from being even more regressive.</td>
<td>Will Indiana’s tax system become even more regressive as the burdens of higher sales taxes fall on lower-income taxpayers shopping locally, while higher-income Internet shoppers buy their goods “tax free”?</td>
</tr>
<tr>
<td>The formula brought property tax rates in very low rate school corporations closer to those prevailing in rest of state.</td>
<td>How would a shift from the property tax to the income or sales tax affect tax burdens in different types of Indiana school corporations?</td>
</tr>
<tr>
<td>The formula permits differences in revenue per student but matches tax rates to those differences.</td>
<td>Could a revised formula match local tax effort to local per-student revenue levels?</td>
</tr>
</tbody>
</table>

A regressive tax system is one in which lower-income individuals pay a higher percentage of their income in taxes than do higher-income taxpayers. To the extent that higher-income individuals are more likely to purchase goods over the Internet without paying a sales tax, then greater dependence on the sales tax to raise state revenue will make the tax system more regressive.

Currently, although the formula has succeeded in bringing up rates at the bottom, urban and suburban corporations still pay rates well above the state average. How would a shift to an alternative revenue source affect these relative tax burdens?

Finally, what makes the Indiana formula unique is that while it permits differences in revenue per student, it matches tax rates to those differences so that higher revenue corporations pay higher rates while lower revenue corporations pay lower rates. Could a revised formula match local tax effort to local per-student revenue levels in this manner?
Conclusion

The property tax is very unpopular in Indiana. While taxpayer opposition is engendered by a variety of factors – including fairness problems due to assessment practices, local differences in property wealth, and the regressive nature of the property tax for low-income Hoosiers – the highly visible collection method contributes greatly to the perception that the tax is onerous. Property taxpayers in Indiana receive one tax notice per year; sales and income taxes are paid in a large number of small, and much less visible, transactions.

If the property tax is to survive as a primary source of school revenue in Indiana, supporters must highlight its strengths: it is a highly stable source of revenue which helps school corporations anticipate future tax revenue, it produces new revenue as additional homes are built, and it is hard to avoid. Yet, these supporters must also address how (1) property tax payments can be more closely related to the flow of cash into the household, (2) the state can soften the impact of taxes levied on unrealized capital gains, and (3) the dramatic increase in taxes that often follows in the wake of mass property reassessments can be lessened.

Reference