

# The Virginia News Letter

## *A Review of the State–Local Fiscal Relationship in Virginia:*

*Not So Good Now and It Could Get Worse*

by Neal Menkes

### Introduction

This article reviews the fiscal relationship between the Commonwealth of Virginia and her localities, examining the relationship's need, its legal basis, and the tensions that sometimes drive both sides to distraction. At the end, I'll suggest some ways to clarify and strengthen the relationship.

But, first let me offer you a joke. You may or may not be amused. The point, however, is to illustrate the attitudes held by some General Assembly members whenever local government officials chide them about state appropriations for financial assistance.

Chernov, the shnorrer (a Yiddish word for a free-loader), had a wealthy patron who gave him a handsome stipend—never less than 500 rubles. One year, the rich man gave him only 250 rubles. Chernov demanded to know why. The wealthy man apologized, saying that his expenses had to be cut because his son had married an actress and stuck him with all of the bills. “Well, of all the chutzpah!” roared Chernov. “If your son wants to support an actress that’s his business. But how dare he do it with my money!”<sup>1</sup>

If you substitute “local governments” for Chernov the shnorrer, “General Assembly” for the wealthy man, and the Personal Property Tax Relief

Act (the so-called “Car Tax Relief Act”) for the son and his actress wife, you have a capsulated version of the 2010 budget debates in which the General Assembly and the governor fully restored state appropriations for the car tax relief program while cutting state aid programs in public education, public safety, and others services.



Neal Menkes

### The State–Local Relationship is Not Close

Unlike computer dating, compatibility is not at the heart of the state–local relationship. The partnership is built on a simple truth. Each side needs the other, regardless of any likes and dislikes. The state relies on local governments to deliver core programs such as education, public safety, and social services. Using local governments for service delivery saves the state from having to hire more employees and provides a bonus of additional local revenues to help shoulder the load. As Virginia’s Secretary of Finance, Richard D. Brown, told a Governor’s Reform Commission subcommittee, the state is “in effect a financier of services” and “not really a service provider.”<sup>2</sup> Although the thrust of Brown’s statement is correct, it should be noted that the state is the direct provider for a number of services including highways (except municipal maintenance), the state police, higher education (including community colleges), and penitentiaries.



*...with fiscal resources significantly dependent upon property rather than income or economic transactions and without the authority to expand or create new resources, local governments are definitely the junior partner...*

## How Do Local Governments Benefit from Their Partnership with the State?

So what do local governments get from this relationship? The answer is plenty. The state provides localities with legal authority along with financial and technical assistance to provide public services. Localities also gain a buffer between them and the federal government – an entity that can understand and translate federal bureaucratic dictates into Virginia-style governance and that can funnel federal dollars from Washington to local governments.

Yes, the fiscal relationship between the state and localities is a partnership, but it is not an equal partnership. Some entity has to be in charge, and from a legal perspective the Constitution of Virginia designates the state, through the General Assembly, as that entity. In matters of establishing or even disestablishing localities, setting public education standards and allocating their costs, or determining property assessment procedures, the commonwealth rules.

- The General Assembly can by general law provide for the organization, government, powers, change of boundaries, consolidation and dissolution of counties, cities, towns, and regional governments. The General Assembly may also provide by special act for the organization, government and powers of any county, city, town, or regional government, including such powers of legislation, taxation and assessment as the General Assembly may determine... (Article VII, Section 2)
- Standards of quality for the school divisions are determined and prescribed by the Board of Education, subject to revision only by the General Assembly. The legislature determines the manner in which funds are to be provided for the cost of maintaining an educational program meeting the prescribed standards of quality, and provides for the apportionment of the cost of such program between the commonwealth and the local units of government comprising such school divisions. Each unit of local government provides its portion of such cost by local taxes or from other available funds. (Article VIII, Section 2)
- The General Assembly can establish the procedure and schedule for assessing local taxes on real estate, coal and other mineral lands, and tangible personal property. (Article X, Section 4)

### Dillon's Rule

In addition, there is a lot of confusion about the application of what is known as Dillon's Rule. The rule stems from an 1868 Iowa court case that was

decided by federal judge John Forrest Dillon.<sup>3</sup> The rule construes grants of power to localities very narrowly. The bottom line is that if there is a question about a local government's power or authority, then the local government does not receive the benefit of the doubt. Under Dillon's rule, one must assume that the local government does not have the power in question. In legal language, the first part of the rule reads like this: local governments have only three types of powers, those granted in express words, those necessarily or fairly implied in or incident to the powers expressly granted, and those essential to the declared objects and purposes of the governing body, not simply convenient, but indispensable. In Virginia, Dillon's Rule is woven throughout the commonwealth's governing and financial relationship with localities through statute and judicial decision.

It is the second part of Dillon's Rule, however, that puts local government powers in a vise. This part states that if there is any reasonable doubt whether a power has been conferred on a local government, then the power has not been conferred.<sup>4</sup> So, what does this all mean in terms of financial resources? As editorialized in the *Virginian-Pilot*, "(c)ities and counties long ago got stuck with the most loathsome taxes because they're not the ones who carved up the revenue pie. State leaders took the taxes that give the least offense. Income taxes are deducted from paychecks. Sales taxes are virtually invisible to most consumers. Localities, by default, were left stranded on the "Island of Misfit Taxes."<sup>5</sup> And, in case you are wondering about the importance of these taxes, the commonwealth collected \$9.1 billion and \$3.8 billion in individual income and sales taxes, respectively, in FY 2010.<sup>6</sup>

What are these local tax monsters that amounted to over \$14.4 billion in FY 2009? First and foremost they include property taxes (see **Table 1**). According to the Auditor of Public Accounts, more than three-fourths of all local tax revenues came from property taxes, a category that includes real estate taxes as well as taxes on personal property, machinery and tools, merchants' capital, and public service corporation property.<sup>7</sup>

Other local taxes include the 1 percent local option sales and use tax, the business, professional and occupational license tax (popularly known as the BPOL tax), the restaurant food tax, taxes on communications, the consumer utilities tax, hotel and motel room taxes, and the motor vehicle license tax. Thus, with fiscal resources significantly dependent upon property rather than income or economic transactions and without the authority to expand or create new resources, local governments are definitely the junior partner in this fiscal relationship.

**Table 2** shows where local governments spent their dollars in FY 2009 and the sources of funds—local, state and federal. In all cases local government was the dominant funding source.

It is interesting to note that the state provided 44.9 percent of the \$13.8 billion spent on public education, with the federal government kicking in another 6.7 percent. Local governments provided the remaining 48.4 percent—a share that has remained fairly consistent in recent years. Yet it is the state and federal governments that drive the preponderance of education costs through their policy- and rule-making roles. As Mel Brooks said in his film comedy, *History of the World: Part I*, “It’s good to be the king.”

As further shown in Table 2, local government provided the lion’s share of funds for expenditures on such important activities as public safety, public works, general government administration, community development, and parks, recreation, and cultural activities. In fact, the Auditor of Public Accounts reported that in FY 2009 the commonwealth provided less than one-third of the revenue for all of local government spending notwithstanding state mandates.

**Table 1: Composition of Virginia Local Taxes, FY 2009**

Tax	Amount (\$)	Share of Total (%)
<b>Property</b>		
Locally assessed real property	8,858,451,612	61.4
Other locally assessed property <sup>a</sup>	1,858,306,745	12.9
Public service corporations property	260,678,902	1.8
Local sales and use	996,750,154	6.9
BPOL	660,068,168	4.6
Restaurant food	403,819,957	2.8
Communications, sales and use	403,392,362	2.8
Consumer utilities	310,586,470	2.2
Hotel and motel rooms	171,787,363	1.2
Motor vehicle license	126,627,741	0.9
All other local <sup>b</sup>	379,536,846	2.6
<b>Total</b>	<b>14,430,006,320</b>	<b>100.0</b>

Source: Auditor of Public Accounts, *Comparative Report of Local Government Revenues and Expenditures, Year Ended June 30, 2009, Amended Version* (Richmond, 2010), Exhibits B and B-2. <http://www.apa.virginia.gov/ComparativeReport.cfm>

<sup>a</sup> Personal property, machinery and tools, merchants’ capital, penalties and interest.

<sup>b</sup> Includes taxes on recordation and wills, tobacco, bank stock, natural resources (coal, oil, and gas), franchise licenses, admissions, and miscellaneous categories.

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### Fiscal Tension: The State Perspective

Thirty-four year ago in FY 1976 the total amount of aid to Virginia local governments was over \$1 billion from all fund sources (state general, state non-general, and federal) according to an article in the archives of this newsletter.<sup>8</sup> The authors wrote “(t)he most notable recent characteristic of Virginia government finance has been its growth; and during the ten-year period 1966-1976, the

**Table 2: Amount and Financing of Locally Delivered Services, FY 2009**

Activity	Total Expenditures (\$)	Share of Funding by Level of Government (%)		
		Local	State	Federal <sup>a</sup>
Education <sup>b</sup>	13,799,138,512	48.4	44.9	6.7
Public safety	4,002,197,359	84.2	12.0	3.7
Health and welfare <sup>b</sup>	2,814,549,454	56.2	25.9	18.0
Public works <sup>b</sup>	1,505,925,371	75.6	22.6	1.8
General government administration	1,022,321,475	94.2	5.5	0.3
Community development	939,727,689	77.7	3.7	18.6
Parks, recreation and cultural	905,757,952	97.7	1.9	0.4
Judicial administration	435,509,274	56.7	41.2	2.1
<b>Total<sup>c</sup></b>	<b>25,425,127,086</b>	<b>61.3</b>	<b>31.6</b>	<b>7.1</b>

Source: Auditor of Public Accounts, 2009 *Comparative report of Local Government Revenues and Expenditures*, Exhibits C, C-1, C-2, C-3, C-4, C-5, C-6, C-7, and C-8. <http://www.apa.virginia.gov/ComparativeReport.cfm>

<sup>a</sup> Includes federal pass-through money from the state.

<sup>b</sup> Excludes state expenditures made on behalf of local government.

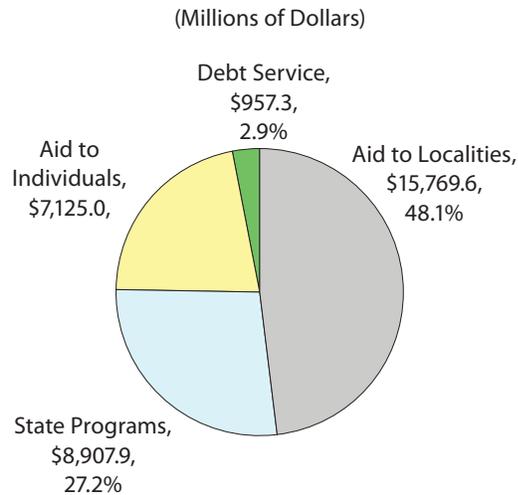
<sup>c</sup> Excludes \$2,41,168 of nondepartmental spending.

*In addition to the substantial general fund appropriations, the car tax relief program irrevocably changed the state-local fiscal relationship.*

fastest growing category was state aid to local governments.” In addition, they found that “(s)ate aid is a major source of funds for local governments in Virginia, composing about one-third of their general revenue.”<sup>9</sup>

How things do change and how they remain the same! Today state financial assistance still comprises roughly one-third of local budgets while almost half of the state general fund budget is appropriated as state financial assistance to localities (see **Figure 1**).

**Figure 1: General Fund Appropriations, 2010-2010 Biennium**



Source: Virginia Secretary of Finance, “Core Services and Trends Affecting Intergovernmental Relations,” Presentation to the Intergovernmental Relations Committee of Governor McDonnell’s Reform and Restructuring Commission, (July 14, 2010), p. 13. <http://www.reform.virginia.gov/Presentations/docs/Pres-RicBrown7-14-10.ppt>.

Since that article more than three decades ago, state general fund dollars alone surpass the \$1 billion from all funds the authors reported as total local aid. Today, just five state aid programs,

comprising over 95 percent of the general fund dollars appropriated for state financial assistance, exceed \$6.7 billion in FY2011 and in FY2012 (see **Table 3**).

### Politics and Economic Growth Push State Spending and Aid to Localities

What propelled the over 600 percent surge in state aid compared to the general fund growth of 455 percent since 1981 as shown in **Figure 2**? The answer is more than “inflation” because the \$1 billion in aid to local governments in 1976 dollars would equal some \$3 billion today.<sup>10</sup> The answer is arguably a combination of the state’s general economic and population growth, and the interplay of policy and politics. Beginning with Governor Charles Robb, state spending on public education surpassed \$1.1 billion in nominal dollars for the first time,<sup>11</sup> and Virginia teachers’ salaries were raised to the highest in the Southeast boosting the state’s national rank from 34th to 26th in the nation.<sup>12</sup> Eight years earlier state education spending barely topped \$404.5 million.<sup>13</sup> Also, voter interest in public education sparked legislative studies and initiatives and more rigorous state standards. All of these actions resulted in substantial state and local investments in education.

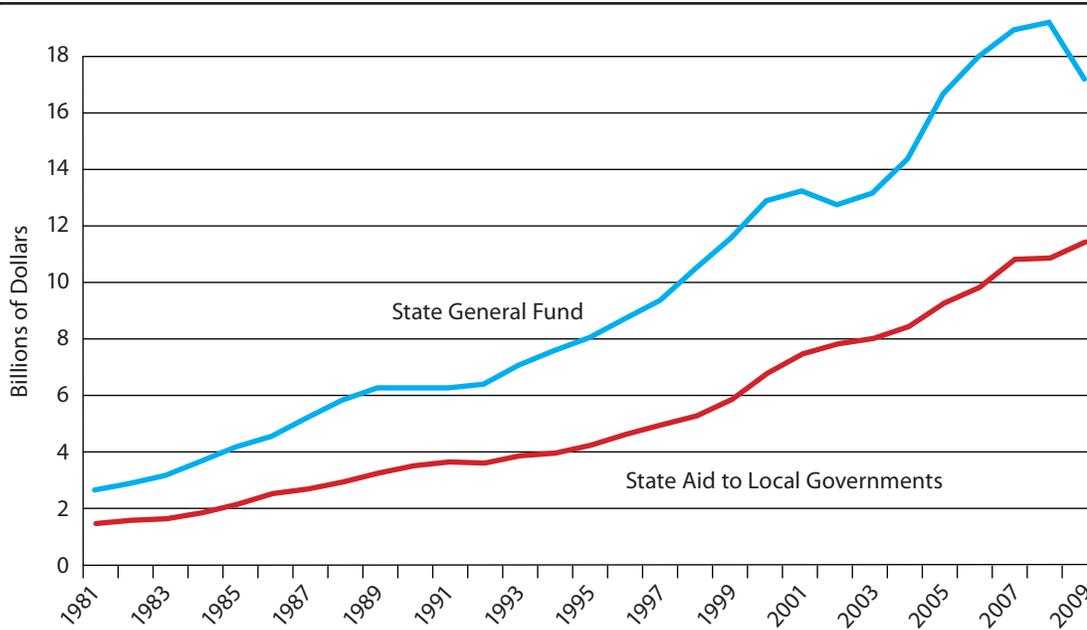
However, the increase in state aid also popped up in some unexpected places. For example, Governor Jim Gilmore’s pledge to put an ax to the car tax led to a tax relief program, which grew from an initial annual appropriation of \$210.7 million to a cap of \$950 million. In addition to the substantial general fund appropriations, the car tax relief program irrevocably changed the state-local fiscal relationship. The state, as “senior partner,” transformed this local revenue source into a political “litmus test” requiring governors and legislators to elevate the car tax relief program as the top

**Table 3: Major Categories of State General Fund Aid to Localities, A Comparison of General Fund Appropriations in Millions of Dollars, FY 2008 to FY 2010**

Category	FY 2008 <sup>a</sup>	FY 2009 <sup>a</sup>	FY 2010 <sup>a</sup>	FY 2011	FY 2010
K-12 direct education aid	5,768	5,608	4,770	4,739	4,903
Car tax relief	950	950	950	950	950
Compensation Board aid for local constitutional officers	618	649	473	592	581
Comprehensive Services Act	294	300	279	272	274
Aid to police departments	216	197	181	179	160
Subtotal	7,846	7,704	6,653	6,732	6,868
Total general fund appropriations	17,263	15,943	14,787	15,377	16,021

Sources: Chapter 847, 2007 Session of the General Assembly, p.508; Chapter 847, 2008 Session of the General Assembly, pp 46, 118, 166, 246; Chapter 879, 2008 Session of the General Assembly, p. 436; Chapter 781, 2009 Session of the General Assembly, pp. 61, 138, 241, 347, 401; Chapter 872, 2010 Session of the General Assembly, pp 34, 93, 149, 226; and Chapter 874, 2010 Session of the General Assembly, pp. 53, 125, 190, 210, 297.

<sup>a</sup> Final appropriation.

**Figure 2: General Fund Revenues and State Aid to Localities, FY 1981 to FY 2009**

Source: Auditor of Public Accounts, *Comparative Report of Local Government Revenues and Expenditures*, editions for fiscal years 1981 through 2009, Exhibit B-1 and Virginia Secretary of Finance, "Review of General Fund Revenues and the Virginia Economy for Fiscal Year 2010," a presentation to the Senate Finance, House Appropriations, and House Finance Committees, August 19, 2010, p. 27.

[http://www.finance.virginia.gov/KeyDocuments/JMCmaterials/RDBAug19JMC\\_GA.pdf](http://www.finance.virginia.gov/KeyDocuments/JMCmaterials/RDBAug19JMC_GA.pdf)

state spending priority. Local elected officials can increase car tax rates but better be able to persuade the electorate that other choices would be far more painful.

Indeed, **Figure 3** tells us that the growth in state aid is not necessarily tied to increases in the state general fund. In some years, state aid climbed while general fund revenues lagged behind. And, in other years, growth in general fund revenue outstripped state financial assistance.

Thus, a state official might assert that there really is no problem in the fiscal relationship. Governors and General Assemblies alike have proposed and appropriated billions of state dollars for education, law enforcement, other core services, and tax relief in good and bad economic times. How can any reasonable person believe that the state isn't living up to its funding commitments?

It is a persuasive argument, but a closer examination of the numbers behind Figure 3, indicates that the spikes in state aid can be traced, in large part, to car tax relief and, even more importantly, to efforts to re-set or re-benchmark public education spending. Re-benchmarking is the process to estimate the total prevailing cost of operating Virginia's public schools, using updated student costs and other technical data. The criticisms of re-benchmarking are twofold: 1) state officials say the cost is too expensive, and 2) locals complain that using two-year old data distorts the true costs.

In the last three biennia (2004-06, 2006-08, and 2008-10), re-benchmarking totaled \$1.2 billion, \$1.5 billion, and \$1.1 billion, respectively.

For the 2010-12 biennium, the re-benchmarking appropriation was in free fall, dropping to \$138 million as a result of the state's revenue challenges, policy changes in education finance, and shifting state budget priorities.

### Fiscal Tension: The Local Perspective

Sometimes local officials feel that the General Assembly and the governor do not listen to their concerns. The state officials hear the locals talk about:

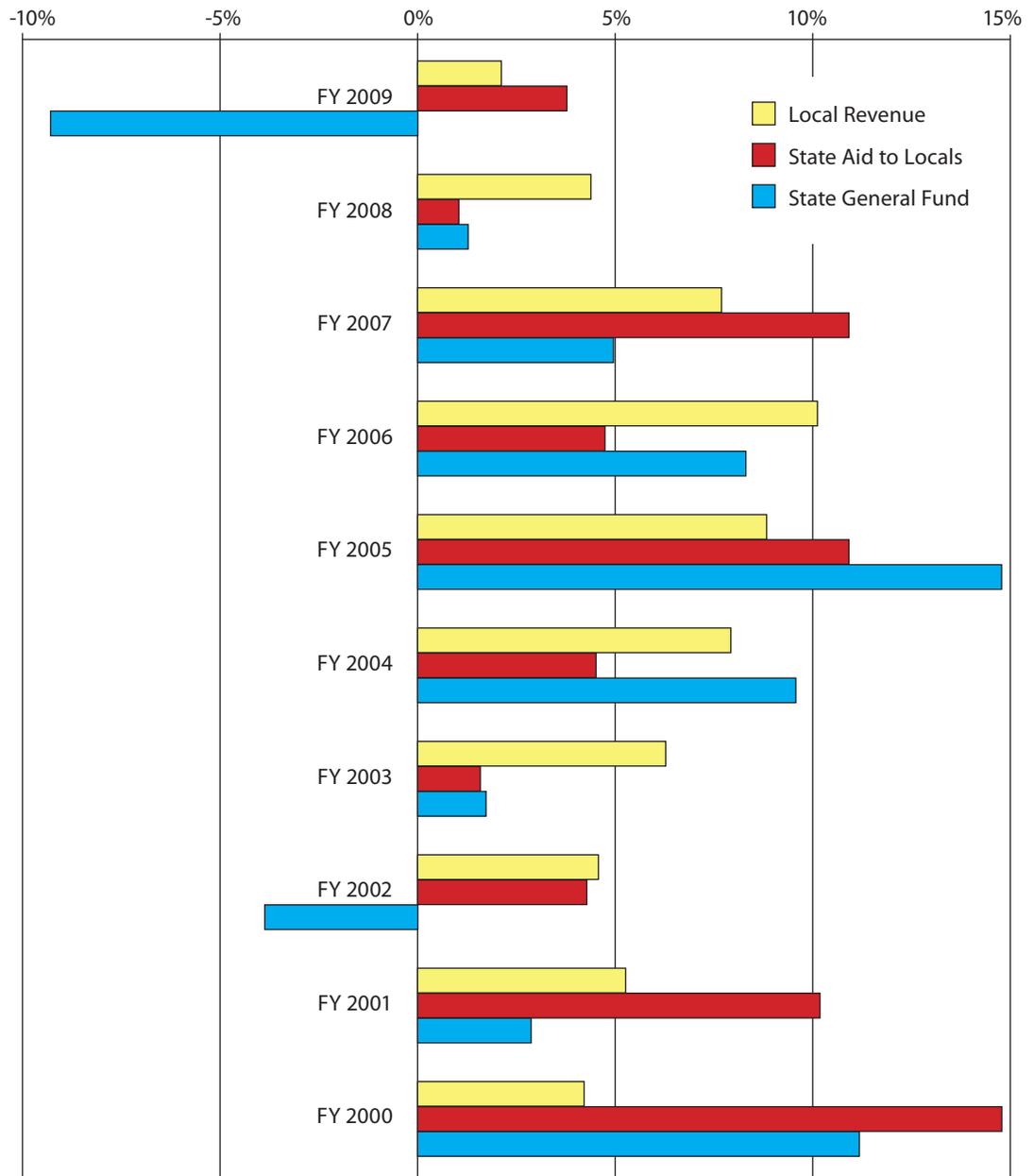
- unfunded or partially funded state mandates in education, local employee benefits, and social services;
- creaky tax mechanisms that fixate on 18<sup>th</sup> century notions of economics;<sup>14</sup> and
- unmet education, transportation and social services needs that hurt economic development efforts.

But do local officials have a case? Take another look at Table 3, which says "Yes they do." Did you notice that the general fund appropriation for public education in FY 2011 is \$31 million less than in FY 2010, \$869 million less than in FY 2009, and a whopping \$1,029 million less than in FY 2008?

**Figure 4** also shows a slump in state support for public education, particularly in general fund dollars. Indeed, without lottery dollars and stimulus money from Washington to prop up the FY 2011 estimated distributions, state support for K-12 would be almost a re-play of FY 2005.

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**Figure 3: Annual Percentage Change of Local Revenue, State Aid to Localities, and General Fund, FY 2000 to FY 2009**



Source: Virginia Secretary of Finance, "Review of General Fund Revenues and the Virginia Economy for FY2010," p.27 and Auditor of Public Accounts, *Comparative Report on Local Government Revenues and Expenditures*, editions for fiscal years 2000 through 2009, Exhibits A and B-1.

*The question confronting cities, towns and counties is how much longer can local taxes make up for state budget cuts*

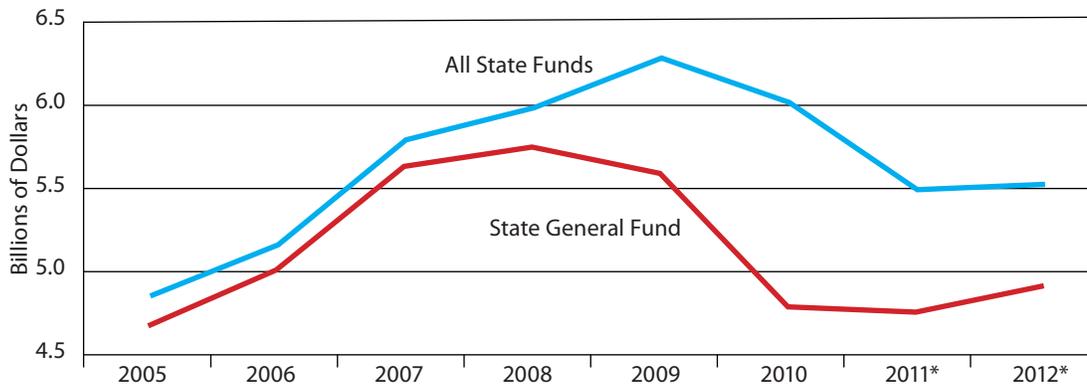
Localities are already spending \$3.1 billion or almost 92 percent more each year than is required to match state dollars.<sup>15</sup> This is not aspirational spending. Local governments make this commitment in order to meet state-promulgated Standards of Accreditation and Standards of Learning. No community wants to boast having an unaccredited school system. And, no one has figured out how to make the slogan "Come invest in our community—both our schools and

students are failing" into an effective economic development strategy.

Although the Car Tax Relief Program has held steady at \$950 million, state support in the other local aid categories has stagnated or dropped since FY 2008 as shown in **Figure 5**.<sup>16</sup>

The question confronting cities, towns and counties is how much longer can local taxes make up for state budget cuts. The answer does not provide comfort. This past summer, the Virginia Municipal League (VML) and the Virginia

**Figure 4: Actual and Projected State Aid for K-12 Education and the General Fund, FY 2005 to FY 2012**



Sources: Virginia Department of Education, Projected State Payments Based on General Assembly Actions for Fiscal Years 2005 - 2012. Includes general fund, lottery, and federal stimulus dollars appropriated by the General Assembly. Does not include the \$249 million appropriated by Congress after the conclusion of the 2010 General Assembly Session. [http://www.doe.virginia.gov/school\\_finance/budget/calc\\_tools/2010-12/fy\\_2010-12\\_conference.xls](http://www.doe.virginia.gov/school_finance/budget/calc_tools/2010-12/fy_2010-12_conference.xls)

\* Projections.

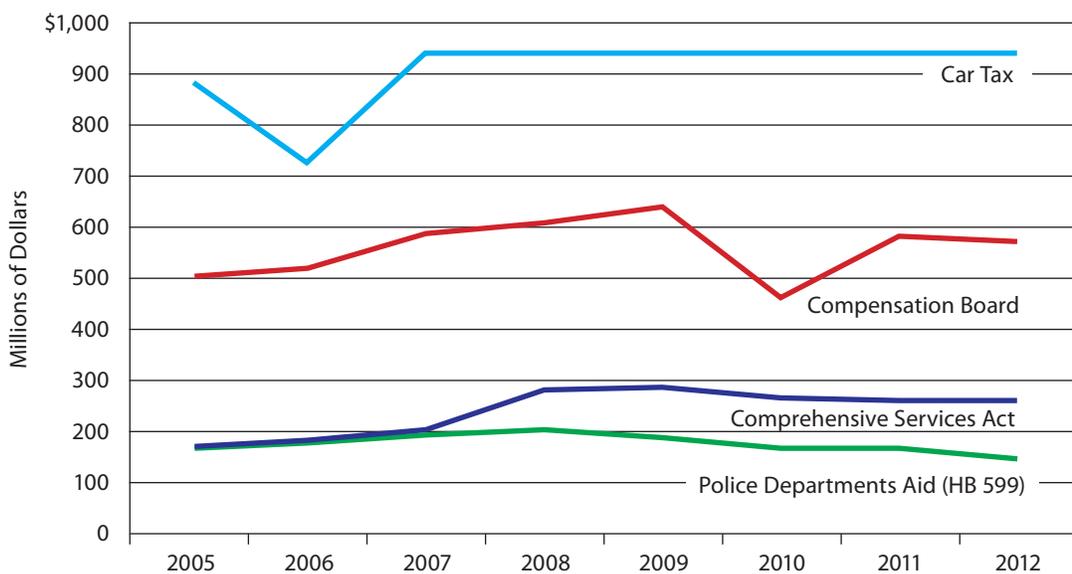
Association of Counties (VACo) took the fiscal pulse of Virginia’s cities and counties through their third annual survey of chief executive officers. The findings were grim. **Figure 6** shows that the basic staple of local finance, the real estate tax, is staggering from the recession and the painfully slow recovery. Since FY 2007, double-digit revenue growth faded to single-digit and now is plumbing negative growth. According to the VML-VACo survey, real estate assessments dropped an average of -5 percent across the state from 2009 to 2010. It is likely that residential assessments will continue to decrease.

Because real estate collections make up so much of local taxes and because of the lingering effect of the recession, local revenue growth actually contracted in FY 2010. This revenue contraction shown in **Figure 7** is expected to continue in FY 2011, although at a lesser rate.

There is a wave of pessimism washing over local governments. Sixty-one percent replied that they are less able to meet their financial needs in FY 2011 as compared to the previous year. And, almost 60 percent believe that this trend will continue through next year’s budget cycle.

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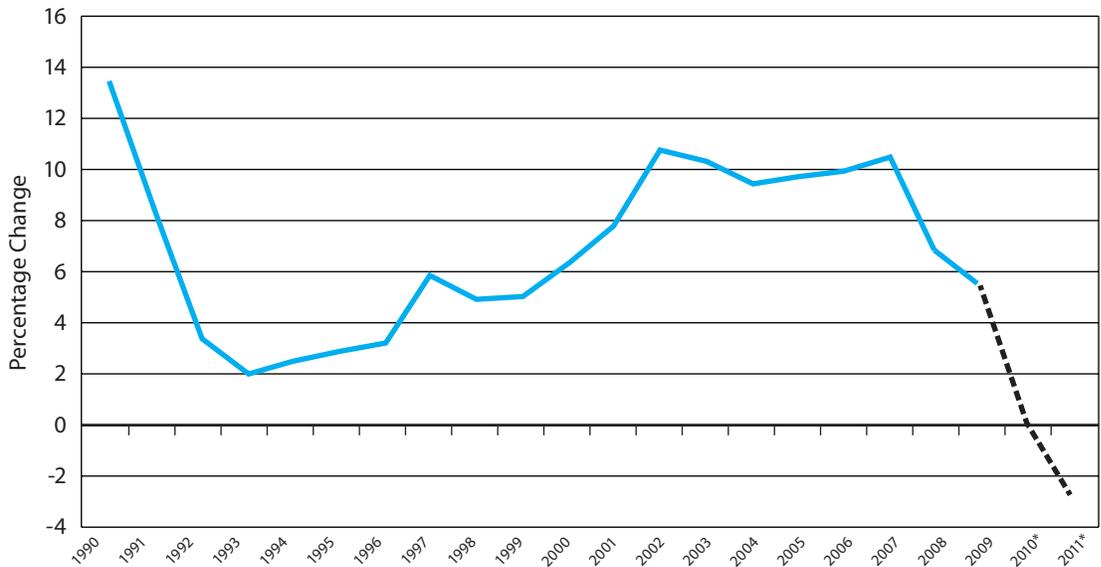
**Figure 5: State General Fund Aid to Local Governments, FY 2005 to FY 2010**



Sources: Selected Appropriation Acts - Chapter 951, 2005 Session of the General Assembly; Chapter 2, 2006 Special Session I of the General Assembly; Chapter 847, 2007 Session of the General Assembly; Chapter 847, 2008 Session of the General Assembly; Chapter 781, 2009 Session of the General Assembly; Chapter 874, 2010 Session of the General Assembly

*With real estate assessments and real property tax revenues in a nosedive since the housing bubble burst, local governments are looking to the state for help.*

**Figure 6: Annual Percentage Change in Locally Assessed Real Property Tax Revenue, FY 1990 to FY 2011**



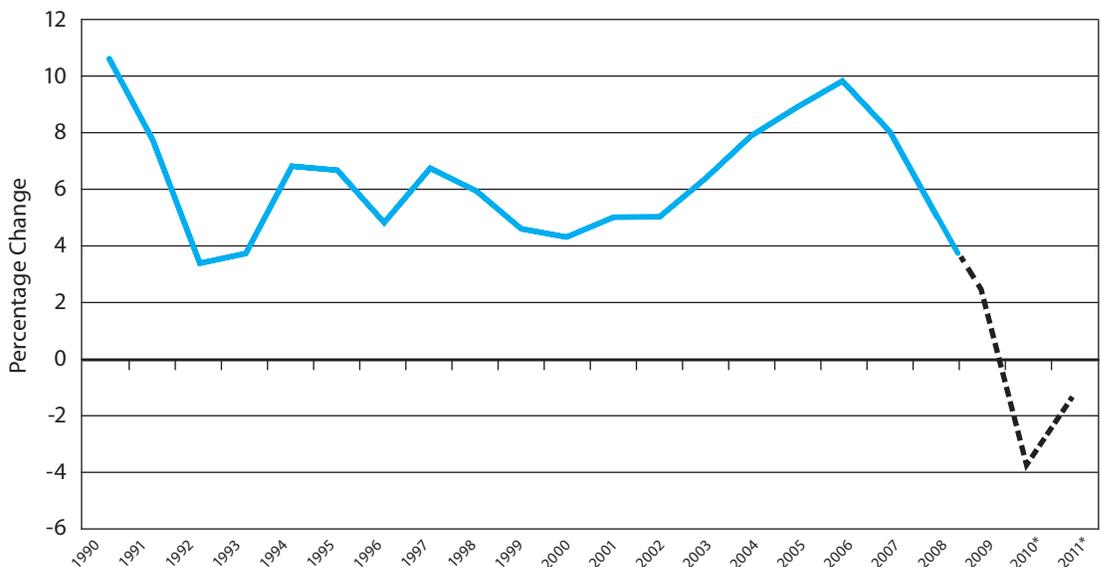
Sources: Auditor of Public Accounts, *Comparative Report of Local Government Revenues and Expenditures*, FY1990 to FY2009 editions, Exhibit B. VML and VACo, 2010 VML/VACo Fiscal Survey--See: Virginia Municipal League Conference, *2010 Local Government Fiscal Survey Results* (October 2010). [http://www.vml.org/CONF/10ConfHampton/10Handouts/9\\_2010LocalGovernmentFiscalSurveyResults.pdf](http://www.vml.org/CONF/10ConfHampton/10Handouts/9_2010LocalGovernmentFiscalSurveyResults.pdf)

\* Forecasts are shown for fiscal years 2010 and 2011.

With real estate assessments and real property tax revenues in a nosedive since the housing bubble burst, local governments are looking to the state for help. However, there is little confidence the commonwealth will come through. To the question: "What are your locality's biggest revenue concerns?" most responses focused on the future of state financial assistance, the general overall decline of state aid, and specific program

cuts in education, the Comprehensive Services Act (CSA) that provides services for high-risk youth and their families, and the Compensation Board that provides partial state funding for constitutional officers such as commissioners of revenue and circuit court clerks. In the survey, state aid concerns even trumped worries over the decline in real property values and taxes by more than 3 to 1.

**Figure 7: Annual Percentage Change in Total Local Tax Revenue, FY 1990 to FY 2011**



Sources: Auditor of Public Accounts, *Comparative Report of Local Government Revenues and Expenditures*, FY1990 to FY2009 editions, Exhibit B. VML and VACo, 2010 VML/VACo Fiscal Survey--See: Virginia Municipal League Conference, *2010 Local Government Fiscal Survey Results* (October 2010). [http://www.vml.org/CONF/10ConfHampton/10Handouts/9\\_2010LocalGovernmentFiscalSurveyResults.pdf](http://www.vml.org/CONF/10ConfHampton/10Handouts/9_2010LocalGovernmentFiscalSurveyResults.pdf)

\* Forecasts are shown for fiscal years 2010 and 2011.

The survey findings illustrate the general uneasiness that the “junior fiscal partner” believes will happen in next year’s session—a session after which all 140 legislative seats are up for grabs. Last session the House of Delegates passed legislation to freeze BPOL rates (HB 57) and to change the burden of proof from the taxpayer to the assessor for appeals (HB 570). Legislation (HB 613) was also introduced to exempt from local taxation new investments in machinery and tools. In peering into a dimly lit crystal ball, the staff director for the Senate Finance Committee told members of VML’s Legislative Committee in August that tax issues including the corporate income tax, BPOL, and machinery and tools taxes could dominate the session. The upcoming political assault on traditional local taxes and shrinking state aid make me wonder if the frayed state-local fiscal relationship can hold. Something has to give.

### Suggestions for a Solution

The General Assembly is locked in a bitter partisan struggle—a struggle that could continue even beyond legislative re-districting and the November 2011 election. While some legislators clamor for more money and resources for core programs, others shout for tax cuts and service reductions. Developing and enacting a state budget becomes increasingly difficult in an environment marked by widely different political agendas. Local governments end up waiting along the sideline for the fallout.

Can anything be done? Absolutely. First, the governor and legislature, as “senior partners” must agree not to:

- further restrict local revenue authority;
- impose new spending requirements or expand existing ones on services delivered by local governments;
- shift state funding responsibilities onto local governments; and
- place additional administrative burdens on local governments for state or joint programs.

Second, the governor and the General Assembly, in concert with local governments, should establish a task force to develop legislative proposals for compelling state agencies to justify standards and regulations, including those in public education, in terms of costs and benefits. Shouldn’t we be measuring performance rather than compliance to determine the success or failure of public services? The task force could also examine what services should state and local governments provide, how such services are sorted between the two levels of government, whether the policies and practices used to determine primary responsibility are appropriate, and which public

services should be considered joint responsibilities. Yes, there have been studies and task forces galore, dating back to the Revenue Resources and Economic Study Commission in the 1970s through the Commission to Study Virginia’s State and Local Tax Structure for the 21<sup>st</sup> Century and the Joint Subcommittee to Study and Revise Virginia’s State Tax Code. But, we have not been in an economic and revenue squeeze like this since the Great Depression. Political leaders may now understand the need for action.

Third, as part of its own budget development and budget deliberation processes, the state needs to develop fiscal priorities that take into account both spending and revenue actions. Should education funding be afforded less priority than certain tax preferences? Perhaps in some situations education programs should be cut, but that decision should be publicly debated and made, and the fiscal priorities should be transparent to the public in both the proposed budget bill and the Appropriation Act. That is not the case today.

I am not including action to modernize local taxing authority. Nor am I advocating for the state to assume all public education funding. A strong case can be made for both, but as Otto Von Bismarck once said, “Politics is the art of the possible.” And that’s no joke. It is time for our state and local leaders to make something good out of this art.

### Summary and Conclusions

Virginia state and local governments need each other, regardless of any likes and dislikes. The state relies on local governments to deliver core programs such as education, public safety, and social services. Localities in turn receive legal authority, and financial and technical assistance, and gain a helpful buffer between them and the federal government. The Constitution of Virginia designates the General Assembly as in charge of the governance relationship. Virginia follows a legal precedent called Dillon’s Rule that limits powers of local governments only to those expressly granted by the state. The state’s financial resources rely on income and sales taxes, while localities must rely on more unpopular and complex taxes such as on real estate, utilities and business licenses.

Local governments provide close to half the funds spent on public education, but the state and federal governments drive the preponderance of education costs through their policy- and rule-making roles. The state in recent years provided less than one-third of the revenue for all of local government spending, while issuing mandates and authorizing new requirements.

*Virginia state and local governments need each other, regardless of any likes and dislikes.*

*To help restore a healthy relationship with localities, the governor and legislature, as “senior partners” must agree not to restrict further local revenue authority or impose new spending requirements or administrative burdens on localities.*

Five state aid programs comprise more than 95 percent of the general fund dollars appropriated for financial assistance to localities: aid to K-12 education, aid to police departments, aid to funding for local constitutional officers, aid to programs for at-risk youths and families, and car tax relief. The car tax relief program established by Governor Jim Gilmore costs \$950 million annually. In addition to requiring the substantial general fund appropriations, the car tax relief program irrevocably changed the state-local fiscal relationship. The state basically took political control over this local revenue source. Local elected officials can increase car tax rates but better be able to persuade the electorate that other choices would be far more painful.

This year the General Assembly and the governor maintained appropriations for the car tax relief program while cutting state aid programs in public education, public safety, and others services. Localities are spending more each year than is required to match state dollars in order to meet state Standards of Accreditation and Standards of Learning. But while the car tax relief program has held steady, state support in the other local aid categories has declined.

There is a wave of pessimism washing over local governments. Many officials say they are less able to meet their financial needs in FY 2011 as compared to the previous year. With real estate assessments and real property tax revenues in a nosedive since the housing bubble burst, local governments are looking to the state for help. But there is little confidence the commonwealth will come through. The General Assembly is locked in a bitter partisan struggle—a struggle that could continue even beyond legislative re-districting. While some General Assembly members clamor for more money for core programs, others call for tax cuts and service reductions. Developing and enacting a state budget becomes increasingly difficult in an environment marked by widely different political agendas. Local governments end up waiting along the sideline for the fallout.

To help restore a healthy relationship with localities, the governor and legislature, as “senior partners” must agree not to restrict further local revenue authority or impose new spending requirements or administrative burdens on localities. The state and local governments together should establish a task force to develop legislative proposals for compelling state agencies to justify standards and regulations, including those in public education, in terms of costs and benefits. Program performance should take precedence over program compliance. The task force could also examine what services should state

and local governments provide, how such services are sorted between the two levels of government, whether the policies and practices used to determine primary responsibility are appropriate, and which public services should be considered joint responsibilities.

Finally, the state needs to develop fiscal priorities that take into account both spending and revenue actions. For example, should education funding be afforded less priority than certain tax preferences? Such decisions should be publicly debated, and made available to the public in the proposed budget bill and, ultimately, in the appropriation act.

#### **ABOUT THE AUTHOR**

Neal Menkes has served as the Director of Fiscal Policy for the Virginia Municipal League since 2007. Menkes researches and analyzes issues related to state and local finance, and he lobbies on behalf of VML-member city, town and county governments with whoever is in earshot. Before joining VML, he worked 14 years for the Virginia Senate Finance Committee and an earlier 14 years for the Virginia Department of Planning and Budget. Neal was awarded a bachelor's degree in history and political science from Emory University. In addition, he earned a master's degree in public administration from the Maxwell School at Syracuse University, but he is also equally proud of the food handler's license issued to him by the township of Livingston, New Jersey.

#### **Endnotes**

Note: When available, web links for sources are shown. At the time of publication all of the links worked. However, some links are unstable and may not work with certain browsers or they may be modified or withdrawn.

- 1 Henry D. Spalding, *Encyclopedia of Jewish Humor* (New York: Jonathan David Publishers, 1969), 29.
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- 7 Auditor of Public Accounts, *Comparative Report of Local Government Revenues and Expenditures, Year Ended June 30, 2009, Amended Version* (Richmond, 2010), Exhibits B and B2. <http://www.apa.virginia.gov/ComparativeReport.cfm>

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13 Salmon, p. 4.

14 The Library of Virginia, Research and Information Services Division, Archives Research Services, Research Notes Number 1, "Using Land Tax Records in the Archives at the Library of Virginia" [http://www.lva.virginia.gov/public/guides/rn1\\_landtax.pdf](http://www.lva.virginia.gov/public/guides/rn1_landtax.pdf)

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16 A budget deal in the 2004 Special Session I included an appropriation cut for car tax relief in FY 2006. However, since that time the General Assembly has consistently appropriated the \$950 million figure as stipulated in SB 5005, 2004 Special Session I.

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