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Current Issues in Local Government Finance

School Reforms, Mandates, Government Reinvention Shape Policy

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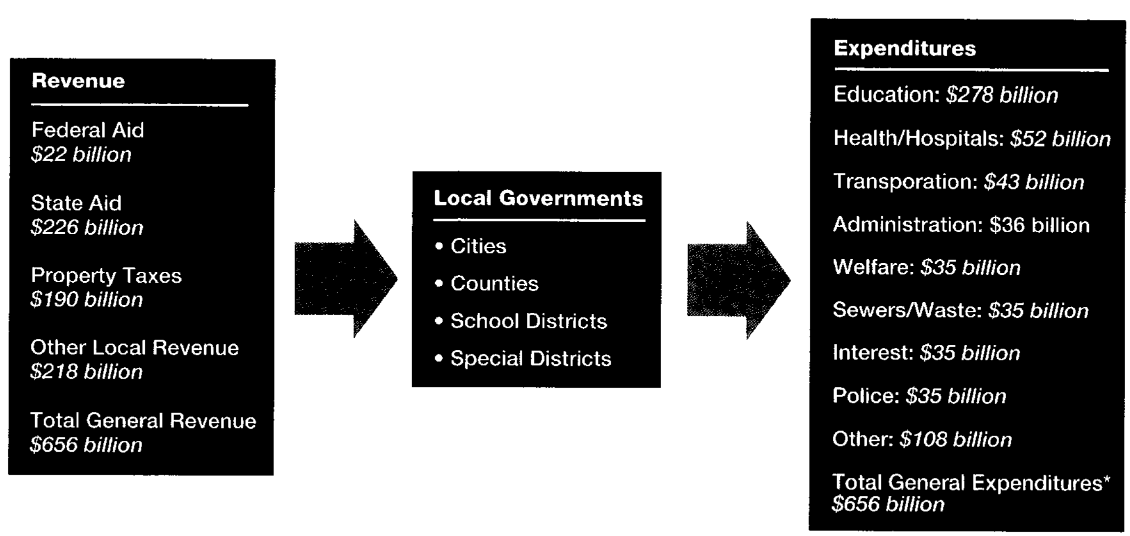
Local governments across the United States will raise and spend an estimated $656 billion in 1994 and employ 11 million people—over half of all government workers in the country. Local governments form a complex web of 87,000 different jurisdictions including city and county governments, school districts, and many "special districts" which typical perform single functions such as water supply. To finance their activities, local governments will collect $408 billion in taxes and other revenue and receive $248 billion in grants from the federal and state governments.

Figure 1 highlights the sources of revenue and purpose of expenditures for local governments in the U.S. The primary local tax is the property tax which will raise an estimated $190 billion in 1994. The largest general spending function of local government is education, totalling an estimated $278 billion in 1994. In addition to

Figure 1
Local Government Finances, Projected 1994



* In addition to $656 billion in general expenditures, local government expenditures on utilities, liquor stores, and employee retirement will total an estimated $98 billion in 1994.

Source: Tax Foundation estimates based on Bureau of Census data.

Table 1
Local Expenditure and Revenue, Percentage Breakdown, 1991

Percentage of General Expenditures on:	Cities	Counties	School Districts	Special Districts
Education	11.4%	14.2%	98.3%	0.0%
Health/Hospitals	6.0	16.9	0.0	26.1
Transportation	10.8	9.1	0.0	13.4
Administration	7.3	11.4	0.0	0.0
Welfare	5.4	14.5	0.0	0.0
Sewers and Waste	10.7	3.4	0.0	14.9
Interest Payments	6.9	5.9	1.7	13.9
Police	11.8	5.3	0.0	0.0
Other	29.7	19.3	0.0	31.7
Total	100.0%	100.0%	100.0%	100.0%

Percentage of General Revenue from:	Cities	Counties	School Districts	Special Districts
State Aid	21.2%	32.5%	51.4%	6.6%
Federal Aid	4.6	2.2	0.7	14.6
Property Taxes	22.9	28.1	37.2	11.3
Other Revenue	51.3	37.2	10.7	67.5
Total	100.0%	100.0%	100.0%	100.0%

Source: Tax Foundation computations based on Bureau of Census data.
Townships not included in table.

general expenditures, local governments operate water, electricity, and gas utilities and liquor stores, and fund employee retirement adding an additional $98 billion to local government expenditures in 1994.

Local government finances are being shaken up by public schooling reforms, costly federal and state "mandates," concern over rising property taxes, and efforts to "reinvent" government. Often these issues are tackled on a statewide basis as state governments exercise significant control over local governments and fund 34 percent of local general spending.

Accurate local revenue and expenditure data is currently available only through 1991, but evidence indicates that local governments have expanded in the early 1990s, despite the recession. A March 1994 study by the Center for the Study of the States (CSS) found that local government employment grew 5.1 percent from mid-1990 to mid-1993. During the same period, state employment grew 3.3 percent and private sector employment dropped 1.3 percent as businesses retrenched. Local government employment growth averaged 1.2 percent annually from 1980 to 1990, but averaged 1.7 percent annually from 1991 to 1993. According to the CSS, these figures indicate that, "governments [didn't] undergo the kind of rigorous downsizing that many private corporations have undertaken in the past several years." Nonetheless, they conclude that, "[c]ompetitive pressures and taxpayer resistance will constrain [future] tax increases, forcing governments to focus interest on 'reinventing' government."

Trends in Local Revenue and Expenditure Growth

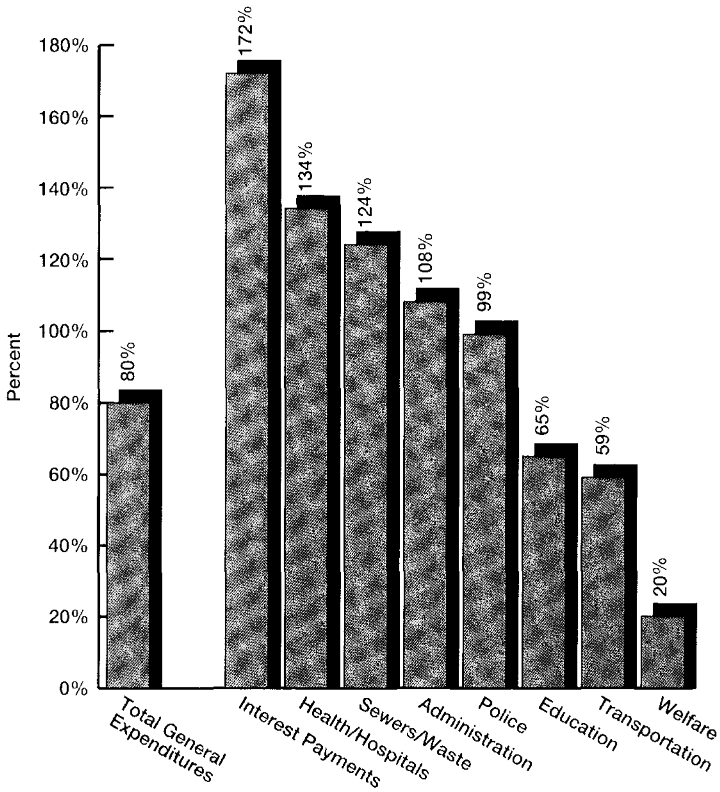
Figure 2 shows 20-year constant dollar growth in local expenditure categories, according to Bureau of Census figures. Interest payments on general debt were the fastest growing spending category—rising 172 percent from 1971 to 1991. General debt obligations, which do not include additional debt issued by local utilities, now soak up over $35 billion per year in local government funds. In addition to interest payments, spending on health and hospitals, sewers and waste treatment, and administration rose faster than the overall spending increase of 80 percent. Education, transportation, and welfare spending rose more slowly than the overall increase.

Health and hospital spending rose 134 percent, in constant dollars. This increase helped push county spending up faster than spending by the nation's cities, since health is primarily the responsibility of county governments (see *Table 1*). The importance of county government has also grown as U.S. population growth has favored suburban counties while many large cities have stagnated.

Along with counties, special districts, also called "authorities" and "commissions," are a quickly growing segment of local government. In many cases, special districts provide efficient region-wide handling of local functions, such as water supply and waste disposal, since they can operate across county and municipal lines. However, it is not clear whether the growth in special districts is ultimately "taxpayer friendly," or not. On the one hand, special districts are usually confined to a single function, so it may be easier for taxpayers to monitor them. On the other hand, special districts can be used to bypass spending and taxing controls placed on city and county governments.

Figure 3 shows growth in the four sources of general funding for local governments: state aid, federal aid, property taxes, and other taxes and fees. Property taxes have risen quickly since 1980, which is a sharp reversal from the 1970s when tax

Figure 2
Percent Increase in Local Government Expenditures (Constant Dollars) 1971-1991



Source: Tax Foundation based on Bureau of Census data.

protest movements were successful in holding the line on property tax increases. During the booming 1980s, as property values shot up and new development took place, property tax revenue flooded into local government coffers. More recently, property tax revenues have slowed, but are still estimated to be rising faster than inflation in the early 1990s. The Department of Commerce estimates that property taxes nationwide rose 6.0 percent in 1992 and 5.2 percent in 1993.

Figure 3 shows that local governments have expanded quickly into non-property taxes and fees. In particular, local sales taxes are now common and accounted for 14.9 percent of local general tax revenue by 1991, compared to just 8.4 percent in 1971. *Figure 3* also shows the divergent trends of federal and state government aid to local government. While federal funding to local governments was reduced during the 1980s, state funding, which primarily goes to fund education, has grown at a healthy clip since 1983.

Federal and State Impact On the Local Balance Sheet

While local governments are heavily funded by higher levels of government, their flexibility is limited by federal and state government "mandates," and by state government restrictions on their structure and taxing and spending authority.

Tax and spending restrictions on local governments have grown since California adopted Proposition 13 in 1978, which restricted property taxes to 1 percent of assessed value across the state. Limits on local property tax rates are now in place in 32 other states. These restrictions vary widely in their ability to slow growth in local government. In some jurisdictions they seem to have done more to juggle local revenue sources than to slow growth in overall taxes. After Proposition 13, California property tax revenue fell from 66 percent of locally-raised revenue in 1977, to only 37 percent in 1991 as other local taxes and fees took their place. For example, during the 1980s local governments in California "malled" the state by zoning endless plots of land for retail development to derive sales tax revenue not subject to tax restrictions.

In addition to tax and spending restrictions, local fiscal flexibility is reduced by state mandates which force local governments to spend money, whether local conditions warrant the extra spending or not. For example, New York State has mandated a uniform level of social services for localities across the state. This requires rural counties with low costs of living to provide welfare benefits as high as that in New York City. The result is that some cities and counties are forced to spend in excess of what is needed and must raise local taxes to pay for it.

State mandates and tax and spending restrictions are causing local officials to complain about being fiscally squeezed. For example, in March, 400 South Carolina mayors took to the street in front of the state capitol to complain that tax protest groups demanded local spending caps while at the same time the state government boosts local spending by mandates.

While local governments around the country struggle with state mandates, both state and local governments must deal with federal mandates. Federal legislation, including the Clean Water Act, Safe Drinking Water Act, Clean Air Act, and the Americans with Disabilities Act (ADA), is having an adverse impact on local balance sheets across the nation and has received stiff opposition from the National Association of Counties (NACo) and the U.S. Conference of Mayors.

Recent estimates by Price Waterhouse for NACo claim that federal mandates cost county taxpayers $4.9 billion in 1993 and will cost another $33.9 billion over the next five years. A companion study done for the Conference of Mayors found that the cost of 10 federal mandates for 1993 was $6.5 billion to the nation's cities.

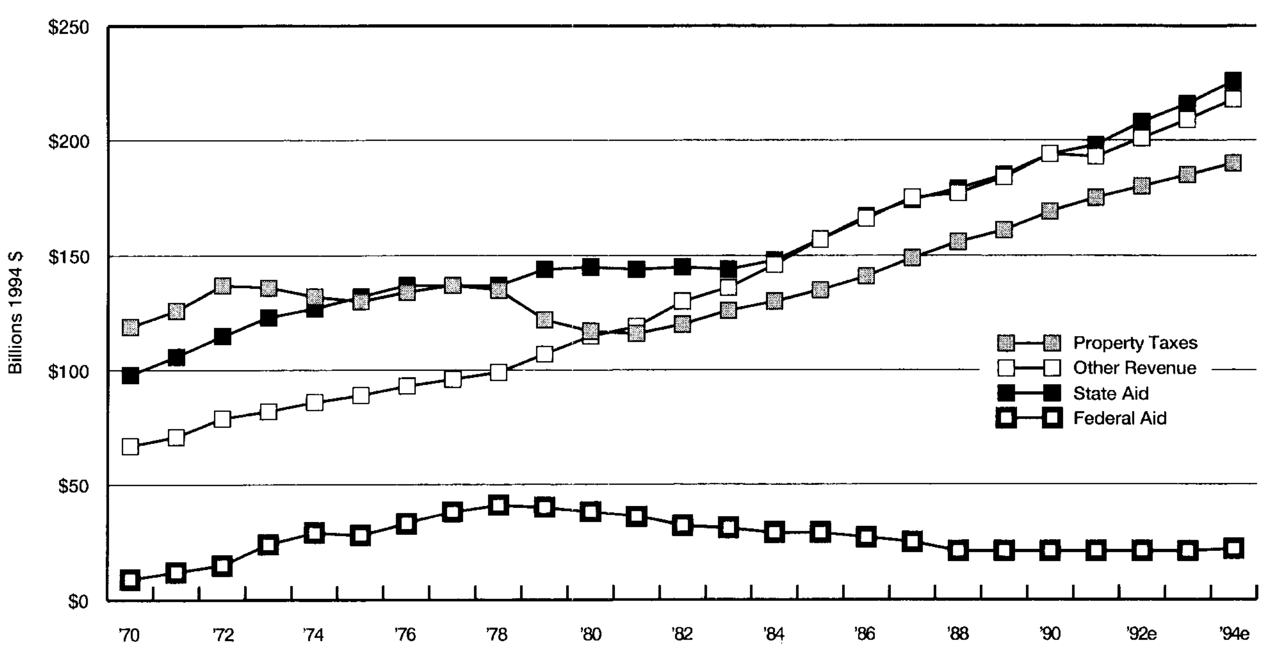
Environmental mandates are particularly costly and are pushing up both local taxes and fees for water and other services. A December 1993 survey by the Center for the Study of American Business found that cost estimates of federal environmental mandates vary from a few hundred to a few thousand dollars per household per year. For example, Columbus, Ohio estimates that environmental mandates will cost the city $1.6 billion over the next 10 years, which works out to $856 per household each year.

Federal legislation can also affect local finances indirectly. For example, the federal Superfund legislation of 1980, designed to clean up abandoned industrial sites, is causing business to desert urban industrial sites, called "brownfields," and head to the "greenfields" in the distant suburbs to build new factories. Superfund legislation attaches liability to businesses or individuals associated with an abandoned industrial site—including new tenants wishing to develop vacant sites. Consequently, old urban sites look particularly unattractive to new development and the resulting flow of businesses out to the suburbs shrinks city tax bases. State governments in Ohio, New Jersey, Michigan, Minnesota, and Wisconsin have either passed or considering legislation to ease such excessive environmental regulations and liability standards in an effort to rejuvenate unused industrial land.

But while higher levels of government impose costs on local governments, local governments routinely pass the buck themselves and impose costs on private citizens and businesses. Professor Steven Eagle of George Mason University noted the trend in the *Wall Street Journal*, March 2, 1994:

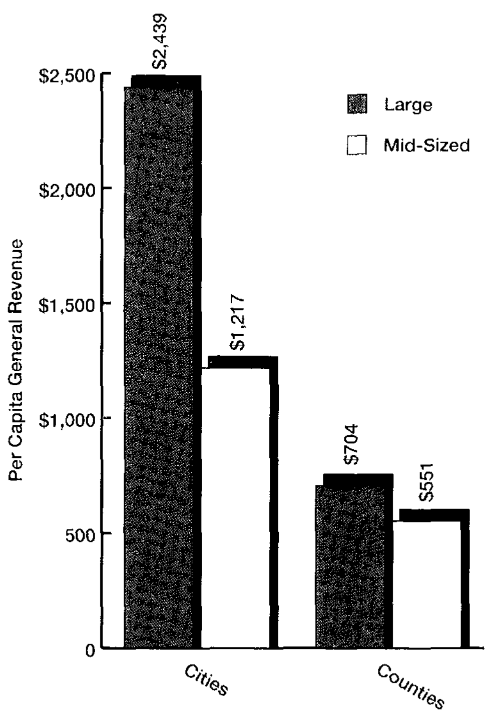
"Financially strapped municipalities increasingly are funding improvements through exactions on development instead of through taxes. Demands for 'on-site' improvements by developers, such as roads within subdivisions, rarely present problems. Exactions for directly related 'off-site' improvements, such as the widening of a side road between a highway and a new regional shopping center, often are reasonable. However, cities from Boston to San Francisco are increasingly

Figure 3
Local General Revenue by Source, 1970-1994 (Constant 94$)



Source: Tax Foundation. Figures for 1992-1994 are Tax Foundation estimates.

Figure 4
Per Capita Revenue by Size of Local Government, 1991



Note: Largest are over 1 million population; mid-sized are 300,000-500,000.

Source: Tax Foundation based on Bureau of Census data.

imposing exactions on developers to fund such general public purposes as public housing or job training centers."

Local Governments Face Mobile Tax Bases

The interactions between local and higher governments allow some local officials to blame others for their fiscal problems. But ultimately, it is local factors which cause some regions and cities to prosper and others to decline. The fiscal soundness of local policy is measured ultimately by the ability to attract taxpaying businesses and individuals to a jurisdiction. According to the Bureau of Census, fully six percent of Americans move to a different county every year, half of these going to a different state, indicating that Americans are very mobile. This mobility is having a dramatic impact on some large American cities. Table 2 shows the population loss in 10 U.S. cities over the past two decades.

For example, an analysis done for the *New York Times* (March 6, 94) shows that 860,000 residents left New York City in the second half of the 1980s, while 815,000 flowed into the city, for a net loss of 45,000. Unfortunately for New York City finances, those who left tended to have higher incomes and therefore paid more taxes than those who arrived, primarily immigrants, who tended to have lower incomes and tended to boost city spending through heavier reliance on social services and education.

Clearly, the financial health of local governments depends on attracting and retaining business and individual taxpayers that pay more into city coffers than they take out. One factor that is causing a migration from many large cities is the significantly higher tax burdens placed on business and individuals in larger cities than in smaller cities. Data for 1991 from the Bureau of Census reveals that cities in the U.S. with over one million residents average $2,439 dollars per capita annual revenue from taxes and fees compared to just $1,217 per capita for mid-sized cities (see *Figure 4*).

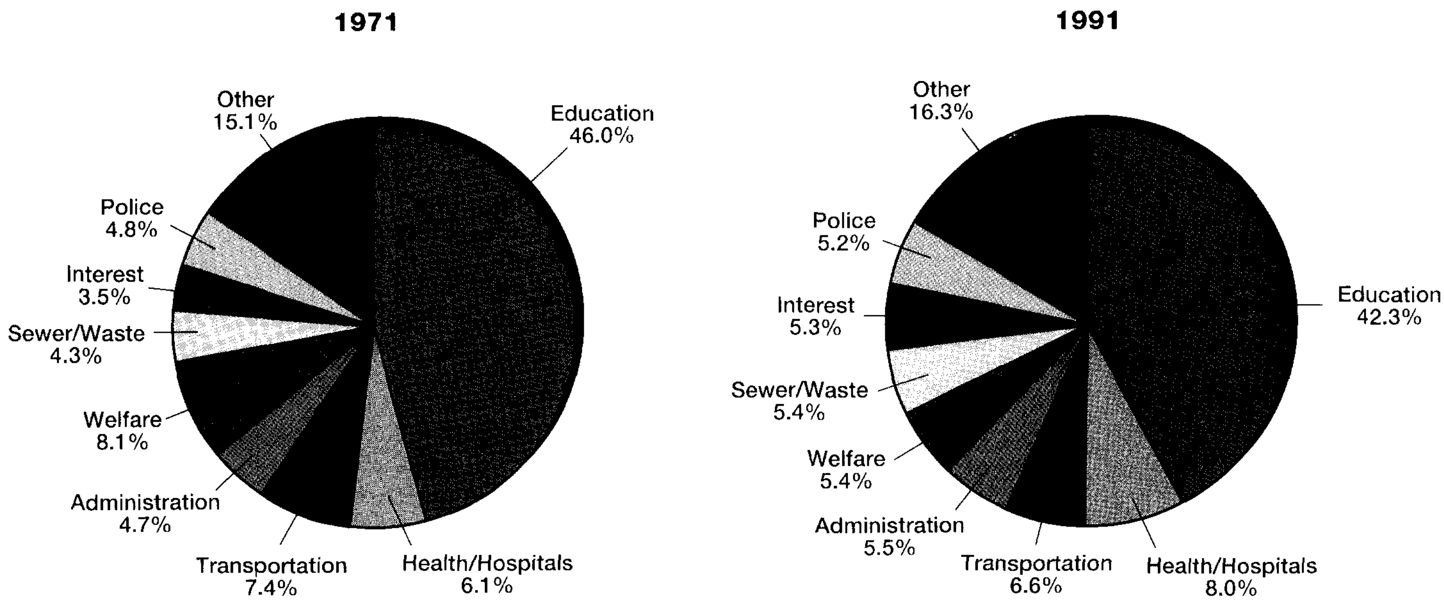
Large cities also look unattractive compared to their own hinterland. A 1993 survey showed that municipal taxes on office space in the downtowns of 12 large U.S. cities averaged $3.39 per square foot compared to just $1.80 for similar space in the suburbs of those same cities. With the tax rate for office space in New York City at $10.38 per square foot, it is not surprising that only 53 of the nation's 500 largest corporations call New York home today, versus 154 three decades ago.

In addition to tax rates, zoning and other regulations have an impact on local business development. For example, in Washington, D.C. the local PBS station has tried for two years to move from suburban Virginia to the District of Columbia, but D.C.'s Zoning Commission kept stalling. *The Washington Post* weighed in on the issue, criticizing the Zoning Commission, which "subjected the station to hours of testimony and cross-examination of the sort usually reserved for the unwanted."

Zoning regulations are increasingly stalling the growth in local tax bases nationwide. The *Wall Street Journal* (March 17, 1994) notes that the "not-in-my-back-yard" syndrome is translating into tighter zoning regulations preventing seemingly innocuous business development, such as movie theaters, laundromats, and car washes. The *Journal* notes how counterproductive these movements are: "... city officials say, NIMBY-movement leaders often also complain about higher taxes and lack of police protection—both of which can be linked to insufficient growth in the local tax base."

Numerous other local regulations dissuade business investment and thereby weaken local tax bases. For example, rent controls cause

Figure 5
Percent of Local General Expenditures, 1971 and 1991



Source: Tax Foundation based on Bureau of Census data.

developers to reduce new development and landlords to leave property derelict and abandoned. For a city or county, the resulting decline in private housing supply means a shrinking tax base on the revenue side of their balance sheet and demands for public housing on the spending side of the balance sheet. Local officials may not at first consider the fiscal impact of such policies since the city balance sheet will not be immediately affected. However, in a long-term view, creating a welcome regulatory climate is essential for local government fiscal health.

Some Cities Reinventing Service Provision

Despite these pitfalls that are causing residents and investment to leave many U.S. cities, some local governments are "reinventing" their fiscal structure to meet the competitive challenge. And large cities, in particular, need reinvention. While problems including poverty and crime cause extra strain on large city finances, virtually every function from fire protection to garbage disposal costs more in large cities, and to a lesser extent, large counties. Whatever the reason for this pattern, local governments must move towards quality service provision at lower costs or they will lose out to other more "entrepreneurial" cities in the competition for businesses and residents.

Large cities may want to consider why small cities are able to deliver services at lower costs. A 1993 study by the Advisory Commission on Intergovernmental Relations (ACIR) helps explain how smaller local governments are able to deliver lower cost services to residents. Rather than producing services "in-house" as large cities tend to do, smaller governments extensively contract out services to private firms or to other local governments.

ACIR analyzed these relationships in the Pittsburgh and St. Louis metropolitan areas which each contained hundreds of small and overlapping local governments cooperating in a rich network of service agreements. Small units of government in these two areas contracted out services such as police to other nearby governments and services such as street maintenance to private contractors. In addition, small units of government rely heavily on volunteer and part-time workers for services, such as fire protection, which lowers the cost of service delivery.

Larger counties and cities have begun to experiment with privatization and contracting out traditional in-house functions. A March 1994 report by NACo found that 38 percent of

Table 2
Population Loss in Selected Major U.S. Cities 1970-1990

	Loss as % of '70 population
Cleveland	33%
Detroit	32
Atlanta	20
District of Columbia	20
Baltimore	19
Philadelphia	19
Chicago	17
Hartford	11
Boston	10
New York	7

Source: Bureau of Census.

the nation's large counties surveyed, planned to privatize some local services in the coming year. Benefits may include lower costs, greater flexibility, and quality improvements resulting from expertise that specialist businesses can provide. Increasing numbers of governments are contracting out services such as building inspection, property tax assessment, airports, waste collecting, recycling, road repair, other public works, social services, fire, ambulance, prisons, and even public school management.

Recent developments include:

• Philadelphia: Mayor Rendell has won wide applause for balancing the city's budget this year for the first time in seven years. Rendell has accomplished this by tough bargaining with the city unions and use of contacting out and privatization. So far, 18 city functions, including operation of the city's art museum, the city nursing home, and trash collection stations, have been contracted out to private firms.

• New York: Inspired by Philadelphia's success, and facing a $2.3 billion deficit, a committee created by Mayor Giuliani has recommended sweeping privatizations and outside contracting for city services and expects such moves would save $500 million per year for New York City. Recommendation for privatization include the city-owned television and radio stations and off-track betting, and the East River bridges. Garbage pickup, bus routes, street-sign and street maintenance, solid waste disposal, parking meter collections, and parking garages are all candidates for contracting out and competitive bidding, according to the committee.

• Indianapolis: Mayor Goldsmith is aggressively shaking up city service delivery and has already subjected over 100 city services to competition and privatization.

• Baltimore: The city has contracted with Education Alternatives Inc. to operate nine public schools for a five year contract. The company is paid a flat fee based on average per-pupil costs in the city. There seems to be significant momentum towards private school management as nine states in the past two years have passed legislation encouraging these experiments. Massachusetts, for example, is setting up "charter" schools across the state that would be run by private operators.

Other cities leading the charge towards contracting out and privatization of city services include Dallas, Phoenix, and Columbus. The "bottom line" for local taxpayers of these reforms remains to be seen. Some reforms, particularly school reforms, are being considered as much for quality improvements as for immediate balance sheet impact. However, quality improvements in local services are a crucial factor in retaining mobile taxpayers in a local tax base. If cities are to take a long-term view of financial health, they must create a welcome environment for businesses and individuals with moderate taxes and efficient service provision.

Shake-Up in Education Financing

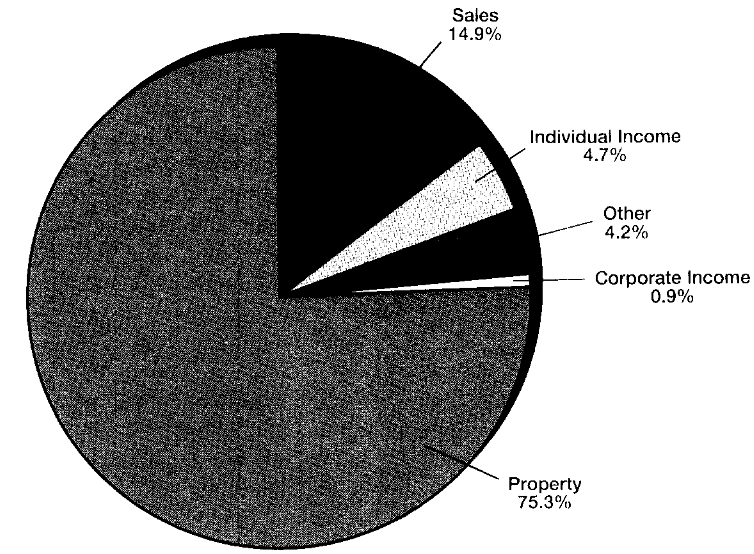
Concern about school quality is one of many forces creating a tidal wide of reform in the K-12 public school system across the country. In addition, inequities in school expenditures across school districts are leading to legislative and legal action to restructure school finances in state after state. Since 1989, courts in eight states have ruled that inequalities in public school funding are unconstitutional. Similar suits are pending in 25 other states.

Momentum for reform also comes from spiralling public school expenditures and the pressure they create to raise property taxes continually. Per-student spending on public primary and secondary schools in the U.S. has risen from $4,501 in 1980 to $6,135 in 1993, in constant dollars.

Spurred by these pressures, many states have instituted reforms:

• Governor Engler of Michigan has spearheaded legislation replacing $7 billion in property tax revenue with a sales tax increase and other state-level tax increases. A March 15 referendum on the plan was strongly

Figure 6
Local Taxes by Type, 1991



Source: Tax Foundation based on Bureau of Census data.

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supported by voters who will see their property taxes cut 33 percent but the state sales tax rise 4 to 6 percent, as well as other tax increases. While the plan provides greater equalization of school funds across the state, it will reduce local control of the schools.

• Following neighboring Michigan, the Wisconsin legislature recently voted to end property taxes for school financing by 1997. Governor Thompson supports the move but there is contention as to the method of replacing $2.7 billion in school funding.

• In Minnesota, the legislature is considering a plan to shift away from property tax funding of the schools. This comes largely as a result of last year's tax revolt in St. Paul, where homeowners received notices that their property taxes could rise as much as 30 percent in the following year.

• Kansas enacted legislation in 1992 that slashed property taxes from $1.833 billion in 1991 to $1.608 billion in 1992 and made up the difference with increased sales and income taxes and used these revenues in a new school finance formula. Elements of the plan have led to a continuing constitutional battle.

• In 1993 the Massachusetts Supreme Judicial Court ruled that public school funding in that state is unconstitutional because higher local property tax collections in wealthier districts created unequal education opportunity. Governor Weld has responded with reforms including minimum statewide spending levels per student and setting up "charter" schools. At least three of 15 charter schools will be run for-profit starting in the fall of 1995. Minnesota and California are already operating "charter" schools which operate with public money but independently from local school boards.

• In 1993 the New Hampshire Supreme Court found that property tax financing of the public schools resulted in disproportionate and burdensome taxation and that the state has a constitutional duty to provide adequate funding for public schools across the state.

• In Texas an ongoing battle surrounds a new school financing formula passed by the Legislature in 1993 which attempts to equalize school funding between property rich and property poor districts. Property-poor districts argue that the law falls short of a Texas Supreme Court ruling regarding funding equity.

• Alabama is currently working to revamp its school funding system after a circuit court ruling that the current system created inequities and was unconstitutional.

Movements are also under way in Nebraska, South Carolina, and other states to shift away from property taxes for school financing. For the taxpayer, school reforms may end up lightening the load of the property tax, but the impact on the overall tax burden is unclear as the school finance burden may simply shift onto state taxes or other local taxes. Kentucky, Nebraska, and Oklahoma, for example, enacted overall state tax increases as part of recent school reform efforts.

Conclusion and Outlook

With 87,000 local governments in the United States, there are many experiments in "reinventing government" to consider. Lessons in school reform and efficient service provision spread from city to city and state to state as governments compete for residents and industry, much the way businesses compete with each other for customers.

A model for local government in the 21st Century may be small groups of elected officials and managers overseeing numerous contracts for specialist businesses competing with each other to provide local services.

Many cities across America are embracing this new "entrepreneurial" city approach. The new mayor in the nation's largest city may be a leader in reform efforts. Mayor Guiliani rode into office promising to slash the city workforce, decentralize power in the city, and turn over traditional in-house city functions to private companies. Clearly, a city facing a $2.3 billion budget deficit needs a new approach.