

RETHINKING REVENUE

PART 1

RETHINKING LOCAL GOVERNMENT REVENUE SYSTEMS

Why is it necessary?

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ABOUT THE RETHINKING REVENUE PROJECT

Local government revenues must adequately fund the public services that a community desires without creating excessive inefficiencies or unfairness in the revenue raising system. However, local government revenue structures are largely based on assumptions that no longer hold today due to digitization, globalization, demography, political changes, and other trends. Furthermore, fairness is becoming an increasingly important concern for public finance. It follows that this concern should include how revenues are raised. For these reasons, the Rethinking Revenue project is taking a fresh look at how revenues are raised. The project will raise new and interesting ideas like those featured in this paper and will produce guidance for state and local policy makers on how local government revenue systems can be modernized. We hope the ideas presented in this paper will spur conversation about the possibilities for rethinking revenue.

The Rethinking Revenue initiative is a collaborative effort involving:

- American Planning Association (APA)
- Government Finance Officers Association (GFOA)
- International City/County Management Association (ICMA)
- National Academy of Public Administration (NAPA) Center for Intergovernmental Partnerships
- National League of Cities (NLC)
- Center of Municipal Finance at the University of Chicago's Harris School of Public Policy,
- Government Finance Research Center at the University of Illinois at Chicago's College of Urban Planning and Public Affairs

The **Rethinking Revenue** initiative is a joint project of many organizations that have an enduring interest in creating thriving local communities and making sure that those communities are served by capable and ethical local governments. Rethinking Revenue is about providing local governments with the ability to raise enough revenues for the services their communities need—and to raise those revenues fairly and in a way that is consistent with community values. This first report from Rethinking Revenue is about defining the problem that local government revenue systems face. As the famed inventor Charles Kettering said, “a problem well stated is a problem half-solved.” The Rethinking Revenue initiative will follow this report with suggestions grounded in proven approaches to reform local government revenue systems.



Why is rethinking necessary?

We contend that rethinking is necessary because local government revenues have not remained aligned with modern economic realities. We will show that this contributes to distortions in the economy and unfairness in how taxpayers are treated. Let's consider the quintessential local government revenue: the property tax. The changing economy has challenged the relevance of the property tax. Most fundamentally, a large part of the value created in the modern economy does not involve property—it often involves less tangible things, like financial instruments or bits and bytes. For example, from 1989 to 2019, the top five fastest-growing categories of wealth held by families were types of financial instruments.¹ This has changed the relative importance of assets in the composition of family wealth. Financial assets increased as share of total assets, from 31% to 42%. The relative share of wealth derived from primary residences and equity in nonresidential property both decreased.² In short, wealth has become less connected with real property ownership and therefore does not represent the taxpayer's ability to pay in the same way it used to.

The sales tax is an important revenue for many local governments. Only recently have sales taxes been applied to online sales.³ Though this has helped keep the sales tax more relevant than it otherwise would be, sales taxes are routinely not applied to many services. Consumers have been shifting more of their purchases to services over the years.⁴ There is not an obvious reason why services should be exempted from the tax.

Wealth has become less connected with **property ownership** and therefore does not represent the taxpayer's ability to pay in the same way it used to.



Other local government revenues have changed over time:

- **Fuel taxes** do not account for the increase in fuel efficiency and electric vehicles.
- **Cable television** franchises do not reflect the “cut the cord” phenomena of consumers leaving traditional cable television for online alternatives.
- Many local governments have become more reliant on **fees and fines**.⁵ Fees and fines are appropriate in many cases because the person who benefits from the service pays for it. However, overuse of fees and fines can lead to unfair and counterproductive outcomes for citizens. An example is court fees and fines that make it harder for low-income people to disengage with the justice system. There have been documented cases where local governments spend more money enforcing delinquent court fees and fines than they collect.⁶

The **overuse of fees and fines** can lead to unfair and counterproductive outcomes for citizens who can’t afford to pay them.

Finally, the American Rescue Plan Act (ARPA) has provided temporary revenue to local governments. Though this is not a long-term solution to the problems with the local government revenue system, it does provide breathing room for thoughtful, considered choices about how to reform revenue. We believe that state and local governments should take advantage of this rare opportunity.



So what if revenues haven't kept up with the times?

Foremost, our outmoded revenue system can result in unfair tax and fee burdens for citizens. Often, who pays the tax does not line up with who can afford to pay or who benefits from public services. For example, people whose wealth is primarily invested in property pay more than those whose wealth is located elsewhere (e.g., financial instruments). Most significantly, lower-income people often end up paying a disproportionate burden of local taxes.⁷ For instance, lower-income people spend a larger portion of their income on taxable goods than higher-income people, so the sales tax often places a disproportionate burden on low-income people.⁸ Also, local governments have come to rely more on fees and fines.⁹ These fees and fines typically aren't scaled to the citizen's ability to pay. Even the property tax can disproportionately burden low-income people. One study found that the burden of the property tax falls disproportionately on the owners of the least valuable homes. To illustrate, property valued in the bottom 10% pays an effective rate that is double that of property in the top 10%, on average across the United States.¹⁰

The disparities created by the existing revenue system are not limited to taxpayers. It creates disparities between local governments, where those governments fortunate enough to have wealthy taxpayers within their jurisdiction can have higher revenues than those that don't. For example, in a state where local sales taxes are important, the city that has the regional shopping center gets all the revenues, even though people from around the region shop there. The communities that send shoppers to the mall have many of the same public service needs but don't get the tax revenue. Another example is where commuters go to jobs in one city but pay little taxes to support public services there.

On average across the nation, property valued in the bottom 10% pays **double the effective rate** of property in the top 10%.

These disparities point to another limitation of the local government revenue system. The sources of revenues that local governments rely on are not necessarily fundamentally flawed. However, over the years, many distortions have been introduced. For example, assessment practices may be intended to benefit certain classes of taxpayers, but this benefit then implicitly comes at the expense of other taxpayers. For instance, there are some states where homeowners get a property tax exemption but renters don't. It is hard to make the case that renters deserve to pay more taxes on a similar property.¹¹ These distortions are often introduced by state legislation. State initiatives to cap local revenue sources or mandate exemptions have compounded local government funding challenges as they limit the options local governments have to fund the service their communities need.¹² Hence, there may be a great benefit available by removing or reducing distortions in existing revenue sources.

The sources of revenue a local government uses to fund itself should reflect the bedrock value of democratic systems of government: fair and equal treatment.¹³ However, the current unfairness in the local government revenue system is not consistent with that value. Bringing our systems of local government in line with this fundamental value and creating a fairer tax and fee system is more important than ever with declining citizen trust in government.¹⁴ In fact, there is evidence that unfair revenue-raising practices even contributed to the 2014 civil unrest in Ferguson, Missouri. This illustrates real-world consequences of unfair revenue-raising practices.¹⁵

In addition to fairness concerns, an antiquated revenue system can result in underfunding of important government services. Infrastructure might be the leading example, as U.S. infrastructure consistently gets subpar marks from the American Society of Civil Engineers.¹⁶ Other examples include poor schools, public health systems, and public safety (as many police reform proposals call for additional resources for more training and new capabilities for first responders). Local governments also have to deal with problems like homelessness and the impacts of climate change.

Outmoded revenues can also warp decisions made about the private economy. For example, one study found that higher sales tax rates encouraged local governments to zone more land for retail and less for manufacturing.¹⁷ However, manufacturing jobs are generally higher-wage jobs.¹⁸ Hence, the tax structure creates a misalignment between the interest of local government and its citizens.

The final concern we will discuss is an increased vulnerability to economic downturns. The demand for many public services doesn't change during economic downturns, and the demand for some services may even increase. This means that local governments need steady sources of revenue. The property tax has usually proven a stable source of revenue for local governments. However, the property tax has become less important for local governments today compared to decades past, as politicians or the electorate sought to limit the amount of money that can be raised. Between 1977 and 2017, property taxes went from 31% to 26% of total local revenues. Some of the revenues that have replaced it, like sales taxes, hotel taxes, or income taxes, are much more vulnerable to the economy. An ideal revenue system would provide steadier resources so that local governments have enough resources available during downturns but without overtaxing constituents at any time either.

Between 1977-2017,
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to an increasing
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What issues will we address in this report and the Rethinking Revenue initiative?

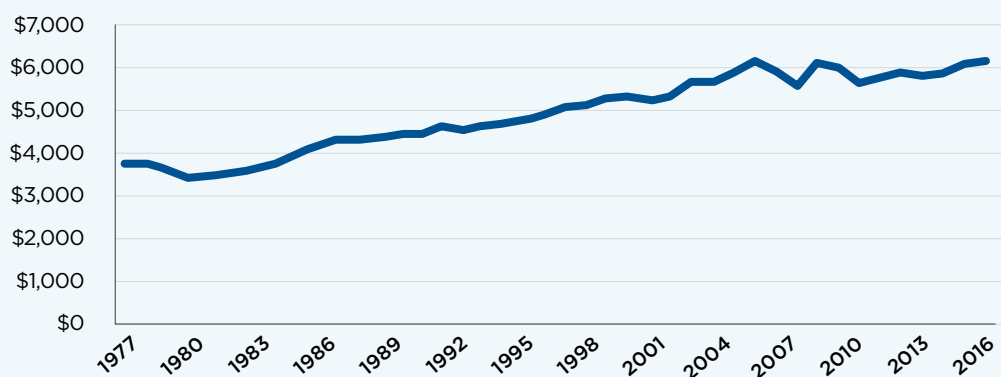
This report is **Step 1** of the Rethinking Revenue initiative. Step 1 is about understanding the current state of local government revenues because, as it has been said, “a problem well stated is a problem half-solved.” We will examine the following questions in the rest of this report.

- ➔ What is the scale of the problem?
- ➔ Can't local governments just spend less?
- ➔ Where does local government revenue come from now?
- ➔ Where does the Rethinking Revenue initiative go from here?

WHAT IS THE SCALE OF THE PROBLEM?

Local governments are a diverse set of jurisdictions, so the scale of the problem varies. When we look at revenue data aggregated across all local governments, we find that total local government revenue has gone up after adjusting for inflation and population growth, as Exhibit 1 demonstrates.¹⁹ However, when we look beyond the aggregated data, there are some important nuances. First, as we will discuss more later in this report, user fees make up an increasing portion of many local government budgets. User fees are the most regressive form of local revenue. Second, the extent to which a local government's population increases and the wealth of its citizens' increases will impact the extent to which revenues stay at least even with expenditures. For example, one study of larger cities found that from 2003 to 2018, larger and wealthier cities enjoyed revenue growth in excess of expenditures, while smaller and poorer cities had higher growth in expenditures than revenues.²⁰ A rethought revenue system should provide all communities with revenue options responsive to local economies and that keep up with the cost of public services.

EXHIBIT 1 | Real Per Capita Revenue for All Local Governments



Another important nuance is the room that local governments have to make choices about their revenue portfolio. Their autonomy is limited by the laws of state governments, and their ability to adjust to shifts in the underlying economy or external shocks is limited by states' actions. For example, nearly nine in ten cities in the U.S. do not have the legal authority to levy an income or wage tax, and around 45% do not have authority to levy a sales tax. Some states also have tax caps and other limits on the revenues that local governments are allowed. Moreover, a local government's ability to propose and implement revenue changes is affected by: a) residents' and taxpayers' demands for services at an acceptable price; and b) the link between the local government's legal ability to implement different types of taxes and fees and whether the underlying economy would support a given tax or fee.²¹ Hence, a local government's "Fiscal Policy Space" (i.e., room to make choices) is bound by state law, what the underlying economy will support, and public demand for government services and willingness to pay for them. Each government's Fiscal Policy Space is unique, which means that we must be careful about drawing conclusions about the fiscal health of cities from aggregate data. Also, though there is not a universal trend across all local governments as to whether Fiscal Policy Space has expanded or contracted over recent decades, changes in the Fiscal Policy Space can limit local government choices about how to best solve local problems. Rethinking local government revenue systems can provide the needed flexibility for local government, while maintaining accountability for how much revenue is raised and how it is used.

CAN'T LOCAL GOVERNMENT JUST SPEND LESS?

There are opportunities for local government to be more cost-effective. We advocate that revenue reforms happen side by side with reforms to make local government more cost-effective. Examples of opportunities to improve cost-effectiveness include but are not limited to:

- ➔ **Local government fragmentation.** There are tens of thousands of local governments in the U.S. It is reasonable to consider if there is too much fragmentation in local government and if public funds could be better used if there were less fragmentation.²²
- ➔ **Pension reform.** Local governments should continue to pursue reforms to public pension plans to ensure they are affordable and financially sustainable.²³
- ➔ **Better budgeting.** Conventional local government budgeting is incremental, where last year's budget becomes the starting point for the next year. This means new costs tend to get layered on top of the old. We encourage alternative ways of budgeting that help governments make better decisions about how to spend limited resources.²⁴

Alternative ways of budgeting can help governments make better decisions about how to spend limited resources.

Learn more:
gfoa.org/rethinking-budgeting.

That said, given the compelling reasons for rethinking revenues that we have described, we don't think cost-cutting alone is an adequate solution. As we stated, there may be challenges that require more spending at the local level, such as infrastructure and education.



WHERE DOES LOCAL GOVERNMENT REVENUE COME FROM NOW?

For readers interested in details about how revenues vary between different types of governments (cities, counties, schools) and different states, you may consult our [online appendix](#). For everyone else, we will summarize here the two major conclusions we can draw that relate to the premise of this Rethinking Revenue initiative.²⁵

First, though there is some variation between states, property taxes are a major source of revenue, on average, for local governments. Sales taxes are also important for many cities and counties. Local income taxes are important in a few states, but in the large majority, they are not a tax levied by the local government. The income tax may still be important to the state government, though. This shows that many local governments are still as reliant as ever on taxes that have important limitations in the 21st century.

Second, there has been more reliance on charges for services and a decrease in intergovernmental revenue for cities and counties. For example, an in-depth study of the 39 largest cities in the U.S. showed that from 2003 to 2018, charges grew so much as to equal tax revenue for half the cities.²⁶ Charges for services are among the most regressive of local government revenue sources, while intergovernmental revenues may often be more progressive.²⁷ This means that local government revenue systems have likely become less fair in the last decade.

From 2003-2018, **charges for services equaled tax revenues** for half of the 39 largest cities in the nation.

WHERE DOES THE RETHINKING REVENUE INITIATIVE GO FROM HERE?

First, in the short term, we are producing a series of reports that highlight innovative ideas to bring local government revenues more in line with modern economic realities, without placing additional burdens on taxpayers. We will support these reports with educational opportunities for local officials and, in some cases, implementation support.

However, these reports will not address many of the fundamental challenges of the local government revenue system that we have described. Those challenges will require a more in-depth examination. Thus, over the coming months, the Rethinking Revenue initiative will address the following questions:

- ➔ **STEP 2. What principles should guide local government revenue reform?** Any major changes to the revenue system should be guided by a set of principles. Ideas for change can be compared to these principles. Step 2 will be about defining these principles.
- ➔ **STEP 3. What reforms to revenues would better achieve the principles of a modern system?** We will examine how existing sources could be reformed and new sources created. We will consider alignment with the modern economy, fairness, and other critical considerations. Step 3 also involves learning more about what the public, private enterprise, and state and local officials think about local government revenues: What concerns do they have? What is important to them?
- ➔ **STEP 4. How can rethought local revenue be made a reality?** We will work with stakeholders in state and local government to put the proposals generated in Step 3 into practice.

ENDNOTES

¹ Based on data from the Federal Reserve's Survey of Consumer Finance. The categories in the top five were pooled investment funds, retirement accounts, stock holds, directly held bonds, and directly held stocks. Note that this is based on average measures of families, which will capture outliers.

² Based on data from the Federal Reserve's Survey of Consumer Finance.

³ For example, it was on June 21, 2018, that the United States Supreme Court stated in *South Dakota vs. Wayfair Inc.* that individual states can require online sellers to collect state sales tax on their sales.

⁴ "Explaining the 30-year shift in consumer expenditures from commodities to services, 1982-2012" Monthly Labor Review. US Bureau of Labor Statistics. April 2014.

⁵ For example, from 2007 to 2012, user charges were the only category of revenue to experience growth among 112 of the largest cities in the U.S., on average. This is based on research conducted by the Lincoln Institute of Land Policy. See Lincoln Institute of Land Policy. "Cities' increasing reliance on fees as other revenues fall." Lincoln House Blog. May 7, 2015. Retrieved from <https://www.lincolninstitute.edu/news/lincoln-house-blog/citiesincreasing-reliance-fees-other-revenues-fall>.

⁶ See Menendez, Matthew; Crowley, Michael F.; Eisen, Lauren-Brooke; Atchison, Noah. "The steep costs of criminal justice fees and fines." Brennan Center for Justice. 2019. Also see: Laisne, Mathilde; Wool, Jon; Henrichson, Christian. "Past due: Examining the cost and consequences of charging for justice in New Orleans." Vera Institute of Justice. January 2017.

⁷ For a broad overview of how taxes impact people of different wealth, see: "Who pays: A distributional analysis of the tax systems in all 50 states." The Institute on Taxation and Economic Policy (ITEP). 2018.

⁸ See: "Who pays: A distributional analysis of the tax systems in all 50 states." The Institute on Taxation and Economic Policy (ITEP). 2018.

⁹ See Lincoln Institute of Land Policy. "Cities' increasing reliance on fees as other revenues fall." Lincoln House Blog. May 7, 2015.

¹⁰“Property tax burdens fall on the nation’s lowest-income homeowners.” University of Chicago Harris Public Policy. March 9, 2021. <https://harris.uchicago.edu/news-events/news/property-tax-burdens-fall-nations-lowest-income-homeowners>. The article describes work done by professor Christopher Berry available at: <https://propertytaxproject.uchicago.edu>

¹¹ We recognize that renters do not pay the property tax bill, but the cost of taxes will ultimately be passed along to renters in the price of their rent.

¹² “Local tax limitations can hamper fiscal stability of cities and counties.” The Pew Charitable Trusts. July 2021.

¹³ For example, in the March 2021 edition of the Grinnell College National Poll, 92% of respondents described “equal treatment regardless of race, religion, and other traits” as “very important” in a democracy, beating out “free speech” (82%) and “peaceful transfer of power” (80%) and tied with “free and fair elections.”

¹⁴ See: “Public Trust in Government: 1958 to 2021.” Pew Research Center. May 17, 2021. Pew’s data is on the federal government. In recent decades, local government has garnered higher levels of trust than the federal government, but there is reason to expect that the forces that are reducing trust in the federal government may also impact local government. See: Kettl, Donald F. “The growing threat to trust in local government.” *Governing*. June 15, 2021.

¹⁵ “Investigation of the Ferguson Police Department.” U.S. Department of Justice, Civil Rights Division. 2015.

¹⁶ See “Report Card for America’s Infrastructure.” <https://infrastructurereportcard.org>

¹⁷ Burnes, Daria; Neumark, David; White, Michelle J. Fiscal zoning and sales taxes: Do higher sales taxes lead to more retailing and less manufacturing? NBER Working Paper No. 16932. 2012.

¹⁸ According to the “Occupational Employment and Wage Statistics” from the U.S. Bureau of Labor Statistics, the average hourly wage for a retail sales person as of May 2020 was \$14.87 compared to \$17.13 for Production workers.

¹⁹ Data is from the Urban Institute’s State and Local Fiscal Conditions data set. In this data set inflation adjustments are based on the consumer price index. There is reason to believe that local government’s costs may often increase faster than the consumer price index because governments purchase a different set of goods. However, even when we account for this the real, per capita revenues of government have gone up.

²⁰ Ahern, Kenneth R. “The business of city hall.” Working Paper 28805. National Bureau of Economic Research. May 2021.

²¹ Pagano, Michael A.; Hoene, Christopher W. “City budgets in an era of increased uncertainty: Understanding the fiscal policy space of cities,” Brookings Institution. July 2018. <https://www.brookings.edu/research/city-budgets-in-an-era-of-increased-uncertainty>

²² See, for example, the series of research reports on local government fragmentation from the Government Finance Officers Association at <https://www.gfoa.org/fragmentation>.

²³ For example, the Government Finance Officers Association has published “Best Practices: Sustainable Funding Practices for Defined Benefit and Other Postemployment Benefits (OPEB)”, January 2016. <https://www.gfoa.org/materials/sustainable-funding-practices-for-defined-benefit-pensions>. GFOA also presented the City of Philadelphia with an “Award for Excellence” for its comprehensive plan to improve the long-term health of its pension system. The Award is intended to inspire other local governments. See: Jacqueline Dunn. “Philadelphia’s Road to Recovery”. *Government Finance Review*. December 2020. https://gfoaorg.cdn.prismic.io/gfoaorg/713d0499-745d-4246-b765-96dc6ebc356f_Dec2020_GFR_Phillly.pdf

²⁴ See, for example, the Rethinking Budgeting initiative, sponsored by the Government Finance Officers Association. <https://www.gfoa.org/rethinking-budgeting>

²⁵ Unless otherwise noted, all data in this section is drawn from the Urban Institute’s “State and Local Finance Data: Exploring the Census of Governments” tool. This tool is based the Census of Governments State and Local Finance series, which comes from the U.S. Census Bureau.

²⁶ Ahern, Kenneth R. “The business of city hall.” Working Paper 28805. National Bureau of Economic Research. May 2021.

²⁷ A study of how state shared revenues are distributed to cities found that there are three common methods of distribution: origin of taxation or consumption; by population, which implicitly redistributes funds without regard to the city’s or residents’ needs, nor to the city’s or residents’ contribution; and equalization or needs-based, which explicitly redistributes funds for the express purpose of providing a floor of revenue to each city. The last of these is explicitly progressive, while population based distribution is implicitly redistributive. See: Kass, Amanda; Pagano, Michael A.; and Farhad Kaab Omeyr, “How States Provide Cities with General Revenue: An Analysis of Unrestricted State Aid,” Lincoln Institute of Land Policy Working Paper WP20AK1, September 2020. Download at: <https://www.lincolninst.edu/publications/working-papers/how-states-provide-cities-general-revenue>



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