Financing Local Government

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Local governments must be viewed in the larger state context. Local governments are authorized by their state government, with the state defining their responsibilities, revenue possibilities, and other factors which affect their abilities to respond to local concerns. State-defined responsibilities include which local services they must provide (such as fire protection, protective inspections, or special education services for children with special needs), and which they can voluntarily choose to provide (or not to provide). State governments affect local governments' options for generating revenues by defining which local taxes are allowed (such as a local income tax or sales tax), maximum tax rates for those taxes, and permissible user or impact fees. The role of the state in defining local governments' opportunities and available choices should not be ignored.

About 38 percent of all spending by local jurisdictions (county and municipal governments, and school districts) in the United States in 1997 went towards education, primarily K-12 schools (all financial data is from U.S. Census of Government). Social services accounted for about 11 percent of total spending, while utilities (such as public water) accounted for another 10 percent. Highways, police, and general administration each accounted for an additional 5 percent of total spending by local jurisdictions. A critical question is how much of this spending is discretionary by local jurisdictions, and how much is mandated by the state or federal government (and thus is under little effective control by local officials).

Local governments and school districts in the U.S. are very dependent upon direct transfers from other levels of government. About 31 percent of their total revenues came directly from state governments (28 percent) and the federal government (3 percent) in 1997. Local taxes accounted for an additional 31 percent of total revenue. The real property tax is the most important local tax nationally, providing about 74 percent of all local tax revenue in 1997. Sales taxes accounted for another 16 percent of total local tax revenue, and income taxes provided 6 percent.

Local governments and school districts are facing several major issues about local finance. These include the downturn in the economy, and its possible impact on revenues; school finance concerns; local tax reform; and the potential impact of an aging population.

Compared to the federal and state governments, local governments' tax revenues are less vulnerable to economic downturns, in large part due to their heavy reliance on the real property tax. But local governments are vulnerable through their dependence upon intergovernmental transfers. As the federal and state governments cope with the economic downturn, intergovernmental transfers could be affected, reducing local revenues. State governments are vulnerable to the economy because of their reliance on sales taxes (25 percent of state revenues in

1997), income taxes (23 percent of state revenues), and federal transfer payments (26 percent of state revenues). At the same time, transfers to local jurisdictions accounted for 30 percent of total spending by states in 1997, which makes such transfers hard to ignore when state budgets must be cut. A 2001 survey by the National Conference of State Legislatures suggests that many states are facing difficult budget problems due to the economy; 37 percent of states had a budget shortfall in 2001, and almost half (43 percent) reported taking 'extraordinary" budget actions for 2002 as a result. The federal budget picture is similarly pessimistic, dealing with both lower revenues than expected and the tax cut. The economic downturn clearly is affecting local governments; a recent study by the National Association of Counties found many counties reporting declining state and federal aid, with rural counties being most likely to report such cuts. About 48 percent of rural county governments said their state aid was declining, compared to only 38 percent of metropolitan counties.

School finance concerns also have important implications for local governments. Many state governments have been reexamining the role of state funding in education, with particular concern about the state's share of the local educational budget. In most states, interest groups have used the courts to challenge the legality of the state systems of school finance; at the end of 1999, such litigation was pending in 43 states.

Local tax reform is another potentially important issue for local governments and school districts. Pressure for reducing the reliance on the property tax continues in many states. These reform efforts generally focus on (1) cutting the amount of dollars that are collected (or at least slowing the growth of increases), and/or (2) shifting to "fairer" local taxes while maintaining the same revenue levels. Such reform efforts have obvious impact on the ability of local jurisdictions to provide service, as well as for the fairness and efficiency of their system of local taxation.

The potential impact of an aging population on local jurisdictions is a fourth important issue. Depending upon the system of local taxation, an aging population can affect the amount of local tax revenues collected, either directly or through political changes in which local taxes are used. Furthermore, an aging population can affect the mix of local services required in the community.