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Changing Revenue Sources For Idaho Cities

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Public concern about taxes has led to legislation and policies that have changed the amount and sources of revenue upon which local governments have historically relied. Property tax collections are now limited, and federal revenue sharing is likely to be greatly reduced in quantity and scope during the next few years.

This publication discusses these changes, how they affect the operations of city governments and how local officials are responding to them to cope with the emerging fiscal situation in the 1980s. Each of the three major revenue sources for cities (property taxes, transfer funds, and fees and user charges) is examined.

The Role of Local Property Taxes

Local governments in the U.S. have traditionally relied on taxes derived from real estate and personal property within their jurisdictions as the basic revenue source for financing the services they provide. This "own-source" revenue is crucial to counties, cities, school districts and other local districts in Idaho.

Traditionally, property tax revenue has been allocated to the city or other taxing district providing the services. The steps are:

1. **Budget** the amount needed to provide the services.
2. **Assess** the value of all property in the city.
3. **Set a tax rate** that will result in the needed revenue.
4. **Collect** the specified amount of taxes from each property owner in the municipality.

This revenue-generating system was accepted and worked quite satisfactorily throughout the U.S. for many years. Recently, however, in Idaho and other states, citizens have reacted against continually increasing property taxes and perceived inequities in the tax. Although the dissatisfaction extends to state and federal taxes, the local property tax is particularly vulnerable to criticism because it is:

- A very visible tax, collected only once or twice a year in a large sum.
- Not directly related to current income in a society where a large part of income comes from salaries and wages.
- Collected and spent locally, giving citizens relatively easy access to government officials and employees.

In Idaho, property tax opposition took the form of an initiative proposal approved in the 1978 general election. This measure provided that:

1. Property be assessed at 1978 market value.
2. Total taxes on a given property cannot exceed 1 percent of 1978 market value (and the total revenue must be divided among the taxing units of which the property is a part).
3. Assessed value cannot be increased more than 2 percent per year as long as the property does not change ownership.

The state legislature has amended the original act (popularly known as "the 1 percent initiative" and patterned after California's Proposition 13) in order to meet constitutional and operational standards. The 1981 legislature changed the initiative, beginning October 1981, to allow more flexibility in the limitation on assessed value. A taxing district may now choose from two options and can choose the one which yields the most revenue. One is that the dollar amount of property taxes can be increased by 5 percent over the largest dollar amount collected in any year from 1978 or after. The second is that the largest amount of tax revenue raised in any year 1978 or after may be increased by multiplying current year tax rates times one-half the increase in market value for assessment

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purposes (Idaho Code, Section 63-2220). Although the form of future legislation is unknown, further amendments to the 1 percent initiative and other property tax laws can be expected.

The difference between the traditional property tax system, which was designed to produce the revenue budgeted to provide services, and the current system into which revenue needs must be made to fit a legislated tax-generating model should be understood. This difference is one of the factors with which local government officials must cope in managing fiscal affairs. The era is past of building a budget without first considering the property taxes available to fund it. The property tax component of city budgets must be developed within a total dollar limit (excluding new property which may come on the tax roles).

Intergovernmental Transfer Funds

The transfer of tax revenues from higher to lower levels of government is not a new concept. The federal government has transferred monies for highway construction to states for many years. States in turn have passed federal monies to counties and cities, as well as transferring state-collected revenues to local governments. However, the scope and role of transfer funds (also called shared revenues) in local government finance is changing.

The major types of state-shared revenues in Idaho are retail sales tax, motor fuels tax and liquor fund monies. A portion of the total revenue collected by the state from each of these sources is transferred to cities and other local governments on a **formula basis.** This is a key feature of formula transfer funds: they are passed on automatically on the basis of predetermined rules. Unless the state legislature (or the U.S. Congress in the case of federally-shared funds) changes the law, the monies will continue to be shared as the formula specifies.

While sales tax revenues are not primarily shared monies, a certain amount of sales tax collections is allocated to local governments, including cities, as compensation for revenue lost by phasing out the business inventory tax. Historical data are used to determine this transfer.

Ninety-eight percent of the motor fuels tax collected by the state is transferred to the State Highway Account. Cities and other local governments receive a portion of these and other revenues accruing to that account. Their shares are determined by population. The transfer of monies derived from operation of the State Liquor Dispensary is also distributed to local governments on the basis of population.

The federal revenue sharing program transfers nationally-collected taxes to local governments. Cities' allocations are determined by:

- Population.
- Tax effort (ratio of state and local tax collections to personal income).
- Relative income (ratio of county to city per capita income).

Federal and state grant monies are another type of transfer fund. The grants must be applied for, they require that certain standards be met (formula factors) and they are competitive (a given number of dollars only are available to the total number of applicants). Grants often specify that the local government match the federal or state money on some percentage basis.

Grant monies, as well as some other shared revenues, are "dedicated" funds. That is, they can be used by the city only for specified purposes. For example, a federal and/or state grant may be made to a city to build a sewer treatment plant. The money cannot be used for any other purpose. Among the dedicated transfer funds are federal and state highway and motor fuels monies which must be used for street and road constructions and/or maintenance, and federal revenue sharing funds which may be subject to certain restrictions.

During the 1960s and '70s, intergovernmental transfer funds became a much more important revenue source for cities. From 1957 to 1977, intergovernmental transfers to local governments in Idaho (counties and municipalities) almost doubled as a percentage of total local government revenue. The amount grew from 22.6 percent in 1957 to 44.2 percent in 1977. From a few dedicated funds (notably streets and roads), formula funds and competitive grants expanded to provide financing for many municipal budgets, both general operations and special projects. However, indications are that this type of funding will become less available in the future, putting an additional burden on local revenue sources.

Intergovernmental transfer funds, both formula funds and grants, will become increasingly fewer and more difficult to obtain. In addition to general reductions, the U.S. Congress is considering changing the transfer of federal funds from formula or competitive allocation to "block" grants, in which states would receive a lump sum of money to distribute and/or spend without restriction. The result of such a system of transfer might well be to politicize the allocation of federal monies within states, in which both geographic areas and end uses are determined by the prevailing political climate. Further, states might tend to follow the federal example in distributing their shared revenue. In such a system, cities could find themselves in a highly uncertain situation with respect to shared revenues.

City User Charges and Fees

Cities have generally charged for "enterprise" services such as water and parking space rental. With the resistance to, and sometimes limitations on, increases in property taxes, cities in many areas of the country are placing user charges on other services where feasible. These include sewage and garbage collection and disposal, and even street lighting, cleaning and snow removal.

Cities are also assessing fees for installation, connection and inspection of utilities in new residential, commercial and industrial structures. Builders and developers either are required to construct and "dedicate" to the city the streets, sidewalks, curbs, gutters, water and sewer lines to service new developments, or they are billed by the city for these "front end" costs of development.

In Idaho, city officials in smaller communities which had new development projects in the last 5 years reported significant increases in user charges and in "front end load" fees and assessments. These increases were sufficient in nearly all cases to recover the cities' costs for capital investments required by growth. Apparently, cities are using direct charges and fee assessments to generate revenue which in the past came from property taxes.

User charges and fee assessments appear to be relatively acceptable to city residents. They represent a system of financing public services by "payment for services rendered." The direct initial costs of a new development, for example, are paid by the builders-owners rather than by all city residents through increased property taxes.

However, several aspects of user-charge financing of city services may result in future problems. Examples are:

- Most Idaho cities have not repeatedly made large increases in their user charge schedules. Should they do so, the type of resistance leveled at the property tax might befall user charges and fees.
- There may be complaints about being charged for services not used (e.g., garbage collection, or snow removal for nondrivers).
- No feasible way has been found to pay for major capital investments, such as water wells or sewage treatment plants, through user fees.
- Unlike property taxes, user fees are not deductible from income tax liability.

Thus, dollar for dollar, user fees have a higher net cost to many taxpayers than property taxes. It may take several years for taxpayers to realize this.

Conclusions

Local government officials are increasingly "policy-takers," not "policy-makers," in the revenue-generating arena. Property tax laws are made by the state legislature; revenue sharing laws are made by the U.S. Congress. In recent years, the state and federal legislatures have changed the reliability, characteristics and quantity of revenue from these major sources. Even in the area of user charges and fees, city officials have little flexibility because of the limited application of these revenue-raising measures.

Because city officials can do little to directly affect the revenue generating capacity of their local government, they must seek to deliver the most needed public services as efficiently as possible. This means developing their fiscal management skills.

One essential key to astute fiscal management is an appreciation of cost-consciousness. Policymakers need to be satisfied that monies spent on a given project are applied in the most cost-effective manner. University of Idaho Current Information Series 614, *Estimating Marginal Capital Costs of Municipal Service Expansion,* shows a method and information needed to determine a city's cost of extending utilities and streets to a new development. This is but one example of applying cost estimation to city operations.

Another ingredient of successful fiscal management is planning. Through the budgeting process, service needs can be matched against available revenues. The process of fiscal planning involves weighing alternatives and making choices. It is an example of facing the all-encompassing economic problem: allocating limited resources among competing and seemingly unlimited needs. University of Idaho CIS 615, *Financial Records in Municipal Budgeting*, shows how financial records of a typical Idaho small city can be made into, and used as, an effective fiscal management tool.

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