

TOWARD  
A SYSTEM OF PUBLIC FINANCE  
FOR THE 21ST CENTURY

A Framework for Public Discussion



NATIONAL LEAGUE OF CITIES



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## BACKGROUND

In February 2000, NLC President Bob Knight, Mayor of Wichita, Kansas, asked the city officials from the Municipalities in Transition Panel to “look at how the economic, demographic, and regulatory landscape of cities and regions is changing and what those changes mean for municipal finance systems.” The Municipalities in Transition panel was established in 1997 to serve as a resource for connecting public policy discussions to the reality of what is happening in America’s cities. The panel is made up of a representative sample of 32 cities from across the country. Elected officials and staff from these cities have participated in meetings at both annual conferences and in-depth interviews on key research issues during the past two years.

For this effort, Mayor Knight asked the panel to focus on three major tasks:

- Reviewing available research and information and examining conditions in Municipalities in Transition cities;
- Identifying key issues related to the future of municipal finance; and
- Developing recommendations for an NLC action plan.

To carry out this charge, the Fiscal Transitions Panel met briefly during the Congressional City Conference, March 13, to focus our work plan. We decided to add a discussion of “principles” along with the analysis of trends and conditions and the identification of key issues. We met again on June 26 to develop this report around these three key sets of findings and a set of recommendations for NLC action. These findings and recommendations are reported below. On July 22, the Chair of the Transitions Panel for 2000, Mayor Neil Guiliano of Tempe, Arizona, presented the report to the NLC Board of Directors. The Board approved the Report, and the Panel with NLC staff are now undertaking the “Next Steps” and substantive agenda outlined here.

Readers are encouraged to send comments to Fiscal Transitions Panel, c/o NLC, 1301 Pennsylvania Avenue, N.W., Washington, D.C. 20004.

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## MAJOR FINDINGS

Beyond its inherent importance, the struggle over sales tax on electronic commerce is also a wake-up call for municipal officials to pay attention to a much broader set of problems. Remote sales are only one of many important challenges to the continued viability of municipal finance. The evolving nature of the economy from one based on manufacturing and property-based wealth to one based on services and knowledge-based wealth creates unprecedented challenges for municipal finance structures. Significant changes in a wide range of factors are creating opportunities and threats for the fiscal arrangements required to support evolving municipal roles.

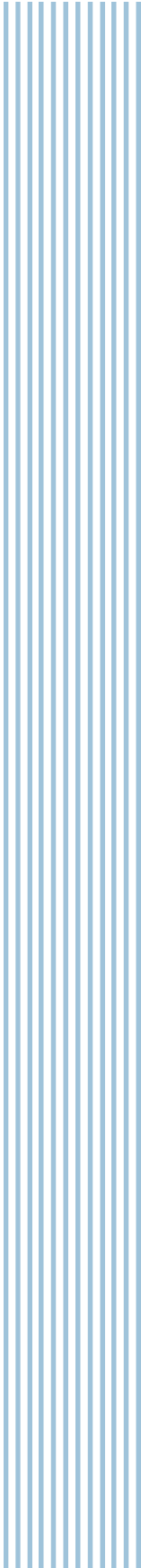

Changing municipal government roles have important implications for the future of municipal finance systems. Devolution of federal and state responsibilities to cities places a heavier burden on local finances. City residents are also demanding more and improved services from their local governments, at the same time that cities are feeling the pinch of state and citizen-imposed limits on taxes. In addition, cities are engaged in a constant struggle between the need to compete and the need to collaborate with their neighboring jurisdictions—spurring decisions that ultimately affect each city's bottom line.

To meet these challenges, NLC should act aggressively and creatively to achieve two main objectives:

- Help municipal officials understand these challenges, recognize their urgency and importance, and take constructive steps locally; and
- Foster and shape a public policy debate aimed at developing the public finance arrangements needed to support evolving municipal roles in the new century.

These objectives cannot be achieved within the confines of existing financial structures of individual municipalities. NLC should approach the problems and the solutions for cities and towns in the contexts of the entirety of intergovernmental fiscal arrangements. This means looking horizontally at the local level – other municipalities, schools, counties, and special districts – as well as vertically to the state and federal governments.

We also must avoid being trapped by current assumptions. NLC should ensure that no conventional ideas go unchallenged and no heresies go unexplored. During the discussions of the Advisory Commission on Electronic Commerce, for example, Dallas Mayor Ron Kirk and Utah Governor Mike Leavitt both suggested that, given the many ways the world has changed and is likely to continue to change, we may need to be open to new ways of thinking about federalism and state/local “sovereignty”.



NLC's studies of municipal fiscal conditions document generally sound local budgets over the past few years. But high ending balances may be temporary and there is no time like the present to take the longer, deeper view. Rising revenues from sales taxes, for example, might have blinded us to the long-term threat of remote sales, but far-sighted NLC studies and advocacy clarified the issue. Big and unnoticed changes beneath the surface will become increasingly dangerous when the rising tide starts to ebb.

NLC should, therefore, continue to provide leadership in helping municipal officials address relevant questions, publicizing this issue and providing the best information about municipal fiscal conditions, and creating frameworks for debate about public finance for evolving municipal roles in the new century.

## THE CHANGING ENVIRONMENT FOR MUNICIPAL FINANCE

State governments determine the immediate contexts and authority for most cities' fiscal arrangements. The state municipal leagues, therefore, are and will remain central to the process of re-thinking and finding solutions. Furthermore, each city and town is unique in some ways, and each will look to its own circumstances. Nonetheless, some common factors do have broad, even if not necessarily universal, effects. NLC can make a major contribution by exploring and illuminating those common factors so that they will be taken into account in specific state and local discussions.

In the short time available for this initial study, we looked at a long list of such factors that have been identified by researchers and analysts. We added some items from the experience of the Transitions Panel cities. That comprehensive list – Trends and Challenges/Opportunities – is attached to this report. (See Attachment A.)

The changing economy is the overarching factor that has the most important influence on public finance. Municipal finance has generally been, and still is, oriented to tangible property and sale of goods. The economy has moved to creating wealth through services, knowledge-based and other new forms of economic activity. Economic activity has also become much more fluid and mobile, crossing jurisdictional lines indiscriminately. Consequently, much economic activity has moved out from under the framework of the municipal revenue system. One result is that the old economy contributes disproportionately to support government services for everybody. A full understanding of the implications of these economic changes for public finance is the first and most important strategic objective of NLC's work plan on this topic.

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As a representative panel of municipalities, we also highlighted the following additional factors as the most prevalent and significant in their effects:

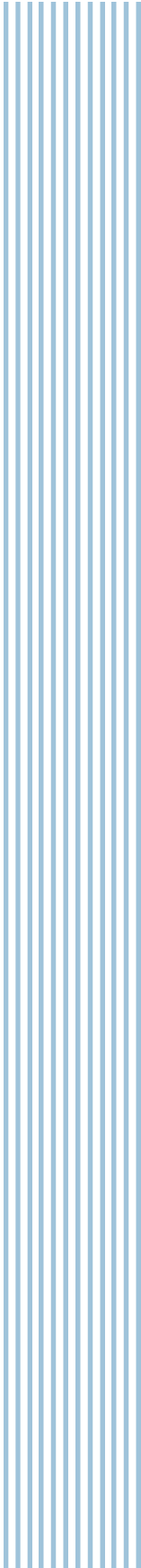
- Continued imposition of federal and state unfunded mandates;
- Technological and management improvements within city government;
- Public pressure to limit taxes and fees;
- Federal and state preemption of local revenue authority;
- Deregulation of telecommunications and electric industries;
- Devolution of responsibilities/programs from the federal government (e.g., welfare reform/TANF); and
- Increasing number of remote sales via Internet and catalogs.

Even this short list provides a glimpse of the broad changes already occurring. We recommend that this list be viewed as a first draft of priority items to be examined. As the Transitions Panel pursues this agenda, we would expect this list to evolve. Further discussion by the Board and other NLC leadership groups can develop and refine the list for a broad, national focus. Others might want to target the list for a specific state or city. Such discussions will also engage and educate participants.

## PRINCIPLES

Amidst changing environments, it is important to have a solid foundation on which to build toward a new system of public finance. One such foundation is a set of principles that can be applied to new circumstances to assess impacts and evaluate options. We have reviewed some of the “textbook” approaches to public finance principles and have built the following set:

- Equity (internal fairness);
- Intergovernmental fairness;
- Adequacy of revenue production;

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- Administrative capacity and cost/effectiveness;
  - Economic effects on individuals and firms;
  - Accountability (transparency);
  - Self-directed governance;
  - Responsibility/responsiveness to broader finance system; and
  - Quality of service delivery.

A fuller explanation of each item is in the attached discussion paper on Guiding Principles for a Public Finance System. (See Attachment B.) The list of principles can be revised, based on further discussions.

## KEY ISSUES

Using the guiding principles as the starting point and applying them to current conditions as well as to likely changes resulting from the factors noted above, we developed the attached list of Key Issues for the Future of Municipal Finance. (See Attachment C.) We have highlighted the following items for initial attention.

- How should economic activity be measured for the purpose of taxation in the context of the new economy?
- How can taxes be collected on e-commerce activity?
- What new or increased needs and/or new or expanded municipal roles are developing that will require municipal attention and increased expenditures?
- What strategies will be needed to address the likely further evolution of political pressure to limit taxation?
- Sales taxes have not been applied to most services. Should they be?
- Property tax revenues are limited by increases in non-profit, tax-exempt property, circuit breakers, mandated lids, or other methods. Should any of these be reduced, eliminated, or redesigned?

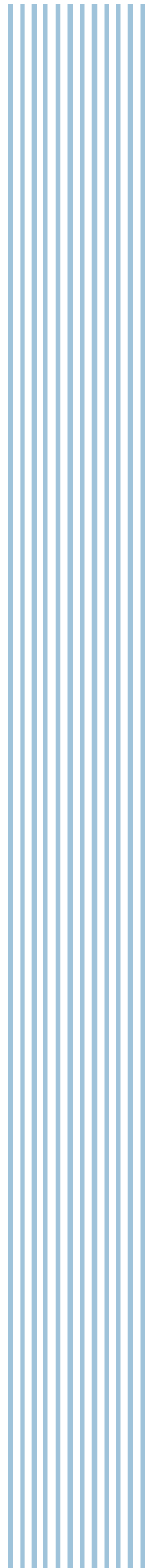
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- What effects on municipal finances will result from state reform of school funding issues? From increased federal expenditures on schools?
  - How should the converging set of industries often called “telcoms” contribute their fair share to the public sector (i.e., all levels of government and then specifically cities and towns)?
  - How can tax structure be used as an active instrument to implement broader policy objectives and outcomes?

Working through these and other issues will produce sets of specific directions and general guidelines that can frame and then shape an on-going public policy discourse about finance. NLC will be able to highlight those general guides and vision, and can also focus on federal issues that follow from them.

## NEXT STEPS

Based on this initial work, the panel recommends that the Board support the following next steps:

- NLC should explore and attempt to quantify the characteristics of our changing economy and its implications for cities and public finance.
- NLC should continue to develop the above-outlined framework for debate about the future of financing for municipalities.
- NLC should engage other stakeholders to identify shared interests and build advocacy coalitions.
- NLC should provide resources that assist city and town officials address these matters. These might include: regular information through Nation's Cities Weekly; conferences, training, speakers, use of technology and other means to increase understanding; and a checklist and process for assessing the threats and opportunities faced by an individual municipality and descriptions of how other cities have successfully conducted such reviews.
- NLC should engage state municipal leagues on these topics and ensure their input to the framing of the public policy discourse as well as provide resources to help guide state municipal league discussions.



- NLC should continue to provide knowledge and information concerning the fiscal conditions and futures of cities including, but not limited to, the use of the NLC web site.
- NLC should conduct outreach directly to key stakeholder groups and through the media to increase visibility and understanding about the evolving roles of cities and the need to maintain adequate finances.
- NLC should identify, develop, and educate key political allies around municipal finance issues.
- NLC should send out this report and framework to key NLC policy committees and constituency groups to get feedback.
- NLC should promote the set of principles (“Guiding Principles for a Public Finance System” attached) included in this report as a starting point for discussions about current challenges and possible new directions for the intergovernmental arrangements for finance.

We look forward to discussing these issues with our colleagues across the nation and pursuing this important research and public policy discussion.

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## ATTACHMENT A

# Trends and Challenges/Opportunities

### ECONOMIC

1. Trend: Dispersion of economic activity out of larger firms.

Fiscal Challenge: Implications of corporate downsizing, telecommuting, and other organizational shifts for city service demands and tax base.
2. Trend: Increasing number of industry groups that have special service needs.

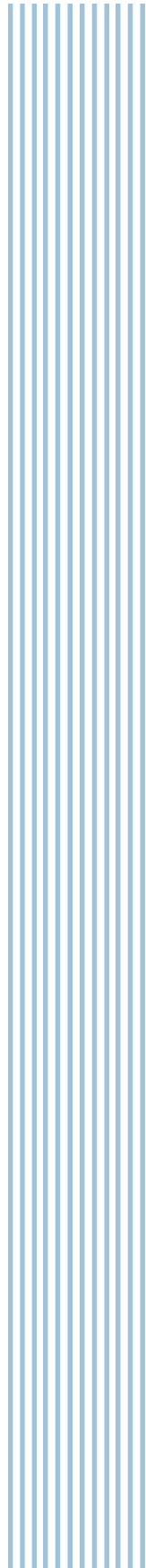
Fiscal Challenge: Pressure on city services. Getting groups to pay their fair share of taxes to finance the services they receive.
3. Trend: Growth of tax-exempt properties.

Fiscal Challenge: Reduces the property tax base.
4. Trend: Mobility of businesses and capital. Interjurisdictional competition for economic activity/tax base.

Fiscal Challenge: Cities sacrificing existing/future tax revenues by providing tax breaks/incentives to businesses to (re)locate/remain in the jurisdiction.
5. Trend: Concentrations and movements of commercial/industrial and residential development throughout regions.

Fiscal Challenge: Shifting tax base and tax base imbalance. Tax base and service level disparities across a region.
6. Trend: Technological and management improvements within city government

Fiscal Opportunity: Improved efficiency, increased revenues, and cost reductions through, for example, outsourcing, fee-for-service, enterprise operations, competitive pricing, special programs, and taxes, etc.



## DEMOGRAPHIC

7. Trend: Demographic changes in city populations such as the aging of America, growing immigrant population, changing household size/composition, residents with special service needs, etc.

Fiscal Challenge: Changing service level needs and demands as well as changing owning, buying, and earning profiles that have implications for local property, sales, and income tax revenues.

8. Trend: Rapid growth, development, and/or sprawl.

Fiscal Challenge: Extra demands placed on city services in order to keep up with fast-paced growth and development including roads, water/sewer, public improvements, etc.

9. Trend: Increasing mobility of people across jurisdictions and between cities for work, shopping, and entertainment.

Fiscal Challenge: Paying for city service needs of non-residentsóworkplace commuters, tourists, and visitors in cities.

## REGULATORY/INTERGOVERNMENTAL

10. Trend: The increasing number of remote sales as a result of (1) the explosive growth of the Internet as a tool for electronic commerce and (2) the large market for catalog sales.

Fiscal Challenge: The political, legal and administrative barriers to collecting taxes on e-commerce and catalog sales.

11. Trend: Federal and state preemption of local taxing authority.

Fiscal Challenge: Limited revenue-raising capacity due to tax caps and restrictions.

12. Trend: Public pressure to limit taxation.

Fiscal Challenge: Limited revenue-raising capacity due to citizen-imposed limits (ballot initiatives, propositions) on taxing authority.

13. Trend: Limits on federal and state fiscal support for cities.

Fiscal Challenge: Tapping into alternative revenue sources to fill the gap.

14. Trend: Federal or state unfunded mandates for localities. In many cases, federal and state laws to limit unfunded mandates have not been effective.

Fiscal Challenge: Cities are forced to find ways to finance these required services/activities and the associated costs imposed.

15. Trend: Devolution of responsibilities/programs from the federal government to local (and state) governments (e.g. welfare reform/TANF).

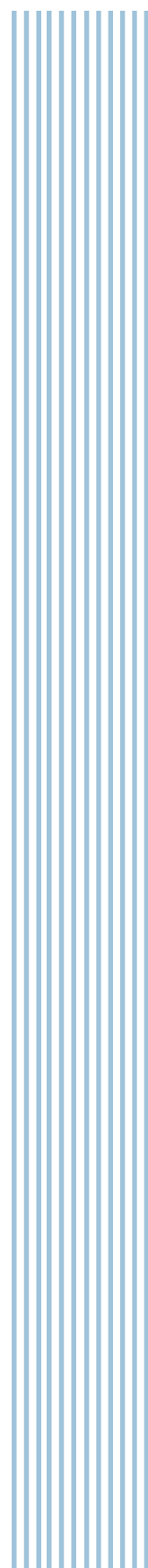
Fiscal Challenge: Cities are under increasing pressure to raise revenue to meet these added service demands.

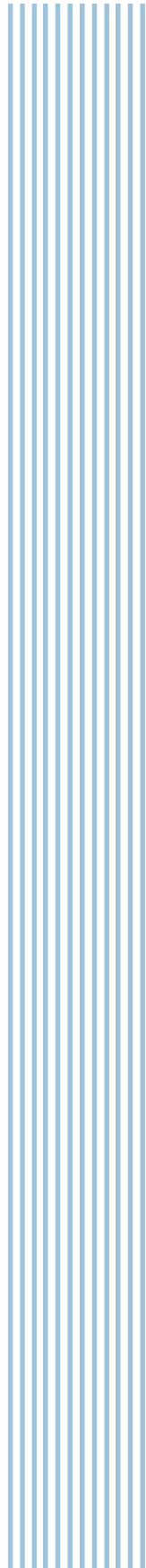
16. Trend: Changes in the federal or state tax system.

Fiscal Challenge: Changes in the tax code related to, for example, local tax-exempt bonds, mortgage interest and local property tax deductions, have implications for the local tax base and financing municipal activities.

17. Trend: Deregulation of telecommunications and electric industries

Fiscal Challenge: Competitive entry into these industries forcing an examination of the practice of specialized taxation of monopoly providers.





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Trend: Regional partnerships, cost-sharing and consolidating services.

Fiscal Opportunity: Cost savings and additional service capacity obtained through such mechanisms as regional taxing districts and joint service agreements with other municipalities, government agencies, nonprofits, and businesses
  
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Trend: Political pressure by special interest groups to limit taxation.

Fiscal Challenge: Limited revenue-raising capacity due to the state legislature giving tax breaks to special interest groups.

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## ATTACHMENT B

# Guiding Principles for a Public Finance System

### Equity (Internal Fairness)

This issue focuses principally on how the city imposes the revenue burden. It includes questions of fairness across several categories, including for example:

- The income or wealth of an individual (which individuals should shoulder the burden, how much should they shoulder, and which element of one's wealth should contribute to the public good);
- Sectors of the community (which groups or industries should shoulder the revenue burden, should the relative burden be compared to their consumption of services or to some other criterion);
- Distribution across income classes (should a fiscal or resource transfer occur from higher to lower income sectors or vice versa); and
- Intergenerational equity (which generation ought to bear the burden of facility construction costs and of program delivery costs based on their consumption of those services).

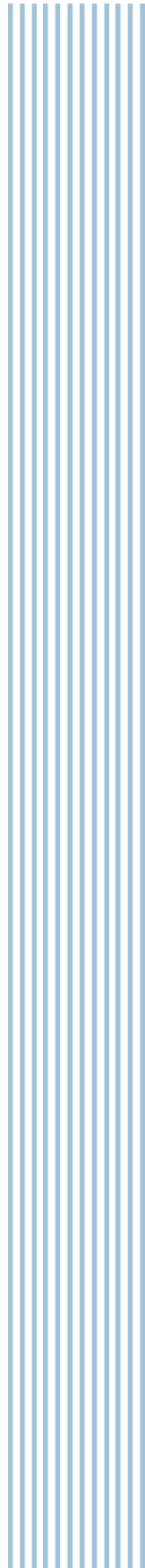
The fairness principle also supports a concern to protect the most financially vulnerable people whose ability to pay for services is very low, even for necessities. This concern can conflict, for example, with reliance on pricing and user fee approaches to financing.

Examples/Considerations. Involves decisions about ability to pay versus benefits, distribution and redistribution of wealth, business and individual shares, groups of beneficiaries and payers.

### Intergovernmental Fairness (External Equity)

Cities generate revenue and provide services in a complex, tangled intergovernmental system. Beneficiaries of a city's services are not always taxpayers to the city. The revenue system should seek to ensure that users of services, regardless of residence, pay for their fair share of the costs of services. Another aspect of this principle involves ameliorating significant disparities among tax bases of jurisdictions, especially relative to need, within a region, a state, and across the nation. These concerns constitute a special, intergovernmental category of the fairness issue.

Examples/Considerations. Involves decisions about services and revenues related to commuters, visitors, and/or tourists to a city; tax base sharing and targeted distribution of state or federal revenues.



### Adequacy of Revenue Production (Productivity)

This concept deals with whether the tax system and individual tax/fee sources generate a sufficient amount of revenue to finance city services and meet city needs. Revenue elasticity and sustainability of fiscal systems become important elements in the adequacy calculation.

Examples/Considerations. Revenue source diversification; revenue source stability/volatility; long-term sustainability of a revenue source; calculation of revenue relative to “need”.

### Administrative Capacity and Cost/Effectiveness (Collectibility)

This is an issue of management capacity. Is the administrative structure in place to collect the tax or fee? Once the administrative structure exists, is it feasible to collect the expected revenues from that tax source? Decisions on tax and fee structures should also consider whether an instrument generates “enough net revenue” when compared with administrative costs. Compliance costs should be a very small part of total revenue collection, unless the purpose of the tax or fee is not related to revenue production but to some other policy objective, such as discouraging a particular activity.

Examples/Considerations. Involves decisions related to administrative structure and costs. Includes decisions about intangible economic activity ñ electronic commerce, intellectual property, and other economic activity that is not explicitly tied to a physical location or point in time and is therefore not easily taxed.

### Economic Effects on Individuals and Firms (Behavioral)

What economic effects are expected with different types of tax structures? Tax systems by their very nature influence individuals’ behaviors. A high property tax might discourage investment in real estate or might encourage migration to other low tax jurisdictions. High sales taxes might reduce consumption of some commodities or might encourage consumption at another location. High marginal income tax rates might encourage an individual to elect more leisure time. Even though tax systems influence behavior, there is a question as to whether the tax system should attempt to be “neutral” and not influence individual behavior. Neutrality implies that tax systems would not appreciably change individual behavior.

Examples/Considerations. Involves decisions about work versus leisure; business operations; location decisions; personal management; investment portfolios; and savings.

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### Accountability (Transparency)

Citizens hold elected officials accountable for the provision of certain services at a certain price, defined as taxes and fees. The more difficult it is for taxpayers to see and understand the levels of city services and to know how much they are paying for such services, the less transparent the fiscal system is and the more difficult it is to hold city administrative and elected officials accountable. Another way of looking at this is that the system of finance, both revenue and expenditure sides, should be understandable to residents, should be adequately communicated to them by the government, and should be politically acceptable to them.

Examples/Considerations. Involves decisions about administration; compliance requirements; visibility of city service delivery and levels; amount of payment.

### Self-Directed Governance

Municipal government is responsible for efficient service delivery and tax levels. Therefore, it should be relatively autonomous in the intergovernmental system. Cities should decide on roles and service levels, rather than those decisions being forced by federal or state governments (unfunded mandates). Cities should decide on revenue levels and sources.

Examples/Considerations. Unfunded mandates and preemptions; revenue and/or expenditure lids and constraints.

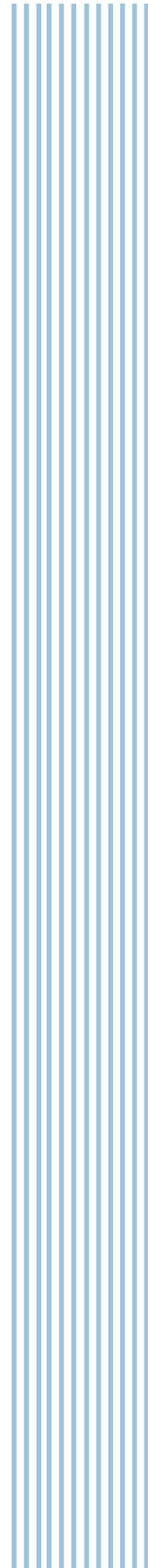
### Responsibility/Responsiveness to Broader Finance System

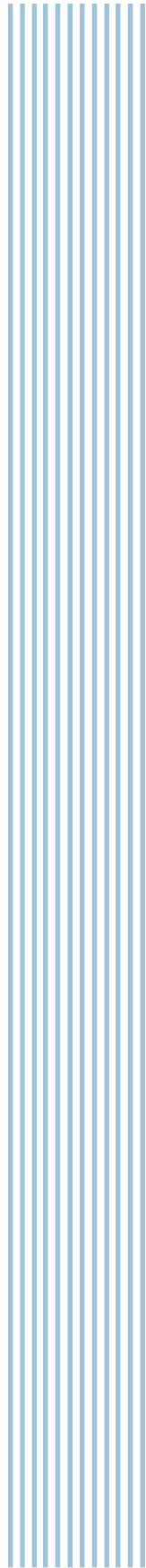
Problems that need to be addressed and opportunities to be seized often spill over into other jurisdictions, which were created with other sets of needs in mind. One jurisdiction's finance and service delivery system affects other jurisdictions. This is clearly the case with federal and state effects on local governments, and it also holds among local governments.

Examples/Considerations. Raises issues of cooperation and control as well as competition and identity.

### Quality of Service Delivery

The production and provision of services and programs by municipalities should be efficient, effective, and productive. City government should communicate information about





these characteristics of services so that residents and officials can make informed judgments about finance questions.

Examples/Considerations. Involves articulating and then achieving purposes/ goals for which revenues are raised.

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## ATTACHMENT C

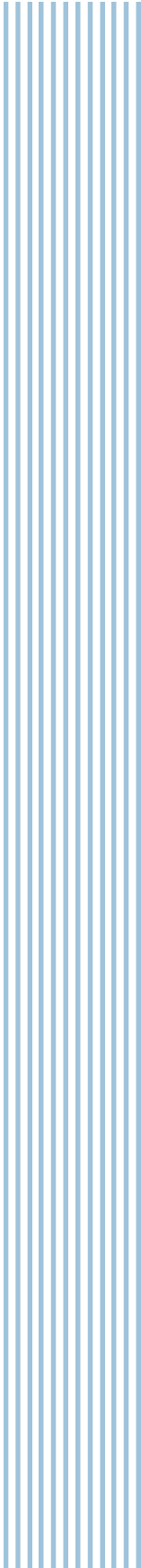

# Key Issues for the Future of Municipal Finance

### Expenditure Issues

1. What new or increased needs and/or new or expanded municipal roles are developing that will require municipal attention and increased expenditures?
2. New Governmental Accounting Standards Board (GASB) standards will emphasize physical infrastructure. How will this affect local budgeting?
3. GASB standards will require showing which functional areas “pay for themselves” versus which rely on general support funds. How will this affect local budgeting?

### Revenue Issues

1. Sales tax bases are eroding because so many exemptions have been made. Should such exemptions be limited?
2. Federal aid as a share of local revenue has declined substantially since it peaked in the late 1970s. What are the proper levels and nature of federal aid to cities and towns?
3. Sales tax has not been applied to most services. This means that a major and growing part of local economies is not contributing and that means that other sectors must contribute disproportionately. Should sales taxes be applied to services?
4. Should tax base disparities among jurisdictions be reduced? If so, how?
5. Should businesses’ share of overall tax burden be maintained, decreased or increased?
6. Can and should ways be found to reduce the use of “incentives” in competition among jurisdictions for tax base (“economic development”)?
7. Property tax revenues are limited by increases in circuit breakers, mandated lids, non-profit, tax exempt property, or other methods. Should any of these be reduced, eliminated, or redesigned?
8. What effect on municipal revenues will result from state reform of school finances? From increased federal expenditures on schools?
9. There has been a steady increase in the revenue cities obtain through a variety of charges and fees. Can this source keep growing? Should it?

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10. How should the converging set of industries often called “telcoms” contribute their fair share to the public sector (i.e., all levels of government and then specifically cities and towns)?
  11. What strategies will be needed to address the likely further evolution of political pressure to limit taxation?
  12. Economic activity pays less and less attention to governmental boundaries. How can revenues be obtained (and then allocated) from this pattern of constant movement?
  13. Can municipalities off-load expensive functions to the county or the state? Is this a good tactic?
  14. How should and can “knowledge-based” economic activity be taxed?
  15. Can local determination of revenues survive the push toward standardization (e.g., one-rate-per-state sales tax, state-shared revenues) from globalizing forces such as the Internet and international trade rules?
  16. Will state aid keep pace with municipal revenue needs? Is the search for increased state aid a good tactic?
  17. Should cities and towns seek access to income-based taxes?
  18. How should economic activity be measured for the purpose of taxation in the context of the new economy?
  19. How can taxes be collected on e-commerce activity?
  20. How can tax structure be used as an active instrument to implement broader policy objectives and outcomes?

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## MUNICIPALITIES IN TRANSITION PANEL

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## About the National League of Cities

The National League of Cities was established in 1924 by and for reform-minded state municipal leagues. It now represents 49 leagues and 18,000 municipalities and 140,000 local elected officials. NLC's mission is to enhance and promote cities as centers of opportunity, leadership, and governance. NLC serves as an advocate for its membership in Washington, D.C., in the legislative, administrative, and judicial processes that affect them. NLC develops and pursues a national municipal policy that addresses the present and future needs of our nation's cities and the people who live in them.

NLC offers training, technical assistance, and information to municipal officials to help them improve the quality of local government in our nation. NLC also undertakes research and analysis on topics and issues of importance to our nation's cities and towns.

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