NORTH CAROLINA CENTER FOR
PUBLIC POLICY RESEARCH INC.

News Release

For release on Thursday, May 9, 1996:
May be broadcast Thursday a.m. and may appear in Thursday newspapers

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LEGISLATURE SHOULD CONSIDER HELPING LOCAL GOVERNMENTS DIVERSIFY REVENUE SOURCES, CENTER SAYS

North Carolina local governments -- strapped by increasing service demands and resistance to higher property taxes -- have increasingly turned to regressive fees to pay for services, says the N.C. Center for Public Policy Research. To counter this trend, the Center says the state should consider granting local governments more discretion to raise other kinds of revenue. The Center identifies four options to deal with this problem.

"Local government officials are caught in the crossfire between those who want lower property taxes and those who demand more and better services," says Mike McLaughlin, editor of the Center's journal, *North Carolina Insight*. "Their primary source of tax revenue is the property tax, and public opinion polls show it is one of the *least* popular taxes. It may be time for the state to help local governments diversify their revenue sources."

Local governments in North Carolina operate under Dillon's Rule, a legal principle meaning they only have authority expressly granted to them by the legislature. While the legislature has granted additional taxing authority to some counties, the only broad-based taxing authority fully controlled by local elected officials is the property tax. However, the unpopularity of the property tax conflicts with citizens' demands for more services and with rapid population growth in some counties.

To determine whether local governments face increased service demands, the Center looked at five indicators over a five-year period. In each instance, the Center found local governments are facing higher demands and higher costs. Those indicators are:

* Medicaid, with caseloads up 77.9 percent;

* Food stamps, with caseloads up 26.6 percent;

* Aid to Families with Dependent Children, with caseloads up an average of 22 percent;

* Public school enrollment, with average daily membership in grades K-12 up 5.7 percent statewide; and

* Law enforcement, with number of arrests for violent crimes up 3.9 percent and the number of arrests for property crimes up 4.9 percent.

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Despite these service demands, the Center found local governments are increasingly reluctant to raise taxes. In the 1995-96 fiscal year, for example, only 8 percent of North Carolina's 525 cities and 27 percent of its 100 counties raised property tax rates, according to surveys by the N.C. League of Municipalities and the N.C. Association of County Commissioners.

The Center's research shows that local officials have responded in four ways to the tension between increasing costs from rising service demands and declining ability to raise revenue from the property tax. County commissioners and city councils have: (1) increased reliance on user charges and fees; (2) shifted more of their tax burden from the property tax to the retail sales tax; (3) increased their reliance on specialized sales taxes authorized by local acts; and (4) turned to flat taxes such as levies on sales of new homes, telephone bills, and motor vehicles, as well as per household charges for solid waste disposal. These levies sometimes are called user fees, but fees that do not vary with the amount of service consumed are really flat taxes. Such taxes are similar to head or poll taxes, which are unconstitutional in North Carolina.

The N.C. League of Municipalities and the N.C. Association of County Commissioners would like to diversify local government revenue sources. These organizations have advocated for a "tax menu" that would allow local elected officials to pick and choose from a number of revenue-raising options which currently are not authorized on a statewide basis. Menu items would range from taxes such as the hotel/motel occupancy tax -- authorized for 99 units of local government in North Carolina -- to relatively untried revenue sources such as an amusement tax or a local option income tax. Also on the menu would be: a local land transfer tax (currently authorized for seven counties); a prepared food and beverage tax (authorized for six cities and counties); and additional sales tax authority (all 100 counties currently levy the full two cents authorized).

The notion of a tax menu gets mixed reviews from state legislators, who note that in the current political environment, it may not be feasible for the state to grant additional revenue-raising authority to local governments. "I can't see us doing anything on taxes now," says Senate President Pro Tempore Marc Basnight (D-Dare). Yet some legislators readily acknowledge that local governments are strapped for funding. "I believe it would be prudent at this stage of the game to look at what options they have and give them some other revenue sources for their use," says Rep. Carolyn Russell (R-Wayne), House Speaker Pro Tem and co-chair of the legislature's State and Local Government Fiscal Relations and Trends Study Committee.

The issue of whether to grant local governments additional revenue raising authority also divided Republican gubernatorial candidates Robin Hayes and Richard Vinroot. Hayes opposes granting local governments additional revenue raising authority through local bills passed by the legislature. Vinroot says additional authority should be granted in most cases.

The Center found the case for a tax menu to be less than clear-cut, but did find convincing evidence of a fiscal crunch at the local level. Local governments have been found to be the most popular level of government in many polls, but their chief revenue source, the property tax, is the least popular. In 1994, for example, 28 percent of respondents in a national poll conducted by the Gallup Organization indicated the property tax was their least favorite tax, compared to only 7 percent who identified the state income tax as their least favorite tax. And federal and state elected officials talk about sending more responsibility to the local level, but little talk is heard about sending more revenue. Therefore, the Center recommends that the General Assembly choose one of the following four options:

Option 1: The N.C. General Assembly could authorize a tax menu for local governments that includes authority to levy one or more of the following: a hotel/motel occupancy tax, a local land transfer tax, a prepared food and beverage tax, an amusement tax, a 1-cent increase in local sales tax authority, and a local option income tax. A broad tax menu could provide something for every unit of government in North Carolina. Poorer counties with fewer taxable amenities such as hotels and restaurants could turn to the local option sales tax or a local income tax.

Option 2: The legislature could authorize a 1-cent increase in the local option sales tax and forgo the remainder of the menu. If adopted statewide, a 1-cent increase in the local option sales tax could provide more than $650 million in annual revenue to local governments (1996-97 fiscal year estimate). One problem with granting additional sales tax authority to local governments, however, is that the state may want to reserve the extra penny for its own future revenue needs. And, there is mounting support for total or partial repeal of the sales tax on food in the 1996 General Assembly, which begins next week.

Option 3: The N.C. General Assembly could approach the fiscal needs of local government from the cost side by relieving local government of expenditures for the local share of Medicaid, Aid to Families with Dependent Children, and Special Assistance for Adults. By assuming the local share of these programs -- $330 million in the 1994-95 fiscal year -- the state would be relieving counties of a significant cost in one of the fastest increasing areas of their budgets. But such a move would not help municipalities with their revenue needs in law enforcement and other areas. In addition, the state may be unwilling or unable to absorb the full cost because the $330 million price tag is more than the $268 million in revenue said to be available this session.

Option 4: The legislature could opt to do nothing to increase flexibility or decrease responsibility at the local level, leaving local officials the current options of property taxes, user fees, and privatization or ignoring increased service demands in favor of lower taxes or no increase in taxes. This option is likely to lead to greater reliance on regressive user fees, increased privatization of services, and curtailment of some services due to reluctance of local officials to raise property taxes to meet rising costs. Aside from the impact on services, a further disadvantage of this approach is that the current trend toward regressive user fees could unfairly shift the burden of who pays for local services to those less able to pay.

The Center found pros and cons to the tax menu approach. In <u>favor</u> of allowing local governments to diversify their revenue sources are arguments that:

* Towns and counties could tailor their tax structure to the strength of the local economy;

* Many menu items already are in place in at least some cities and counties;

* Additional flexibility would be consistent with the trend toward returning authority to the local level;

* Local government is the closest to the people, so voters can more easily hold elected officials accountable for taxing decisions; and

* Cities and counties are turning to flat taxes disguised as user fees that are even more regressive in the way they distribute the tax burden than the proposed menu items.

The <u>cons</u> of a tax menu include the following:

* Some of the menu items -- such as the meals tax, hotel/motel tax, amusements and land transfer tax -- would not help some of the less populated and poorer rural counties that need help the most;

* These same taxes target specific industries or types of businesses, which raises the issue of fairness;

* Some of the menu items -- such as the local option sales tax -- are regressive and would shift the tax burden away from wealthy individuals and businesses that own large amounts of property;

* The state may be less willing to share revenue with local governments if it grants additional tax authority, which could hurt poorer towns and counties that have fewer resources to tax; and

* Local officials already have broad constitutional authority to raise property taxes to meet their revenue needs.

Rep. Leo Daughtry (R-Johnston), the House Majority Leader, is not enthusiastic about a tax menu but is sympathetic to relieving pressure on city and county program costs. He notes that one possibility might be to ease the burden on the counties from the cost side by assuming the local share of costs for Medicaid, Aid to Families with Dependent Children (AFDC), and Special Assistance for Adults. Such a move would relieve counties of some $330 million in mandated expenses and would particularly benefit low-wealth counties with proportionately high social services caseloads. "It [would be] a tax cut for the counties, rather than having it go straight down to the people," says Daughtry.

As an example of a place where service demands are increasing the pressure on local governments, Daughtry need look no further than his home county of Johnston. Johnston County increasingly is becoming a bedroom community for neighboring Wake County and Research Triangle Park. As a result, the county's population of school-aged children has exploded -- requiring the equivalent of one new school every year to house all the new students. The county's share of Medicaid spending grew from $500,000 in the 1989-90 fiscal year to $2.7 million in fiscal year 1995-96.

The N.C. Center for Public Policy Research is an independent, nonpartisan, nonprofit corporation created to study public issues facing North Carolina and to evaluate state government programs. The Center is supported in part by grants from the Z. Smith Reynolds and Mary Reynolds Babcock Foundations, both in Winston-Salem. Additional funding comes from 13 private foundations, 190 corporate contributors, and more than 900 individual and organizational members. In addition to publishing *North Carolina Insight,* the Center issues book-length research reports and publishes biennial rankings of legislators' effectiveness. Recent studies by the N.C. Center have examined school vouchers, pesticide regulation, state-owned railroads, and how the state's public universities evaluate and reward teaching.

Copies of *North Carolina Insight* containing the Center's research on the increased service demands and the debate over whether to diversify local revenue sources for local governments are available for $11.50, including tax, postage, and handling. To order, write the Center at P.O. Box 430, Raleigh, NC 27602, call (919) 832-2839, or fax (919) 832-2847.

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For more information on increasing service demands and revenue options for local government, contact Mike McLaughlin at the Center at (919) 832-2839.

Table 5. Examples of Increased Service Demands on Local Governments in North Carolina

SERVICE PROVIDED	FY 1990–91	FY 1994–95	CHANGE
Aid to Families with Dependent Children[1]			
Average Number of Monthly Recipients Per County	2,522	3,077	+22.0%
Average Monthly Payment Per County	$242	$228	-5.8%
Average Monthly Administrative Cost Per County	$35,957	$46,449	+29.2%
Medicaid[2]			
Average Number of Monthly Cases Per County	2,923	5,199	+77.9%
Average Monthly Payments to Vendors Per County	$1,432,709	$2,583,097	+80.3%
Average Monthly Administrative Cost Per County	$43,406	$57,516	+32.5%
Food Stamps[3]			
Average Number of Monthly Recipients Per County	4,882	6,180	+26.6%
Average Monthly Administrative Cost Per County	$39,063	$47,459	+21.5%
Law Enforcement[4]			
Number of Arrests, Violent Crimes	24,991	25,967	+3.9%
Number of Arrests, Property Crimes	56,093	58,394	+4.1%
Public School Enrollment[5]			
Final Statewide Average Daily Membership, K–12	1,070,297	1,131,090	+5.7%

[1] Division of Social Services, *Statistical Journal*, Table 1, pp. 1–2, State Fiscal Years 1991 and 1995, Planning and Information Section, N.C. Department of Human Resources, 325 N. Salisbury St., Raleigh, N.C., 27603. Counties are responsible for 50 percent of the AFDC administrative costs and about 16 percent of the AFDC payments. Preliminary data show that AFDC caseloads could decline substantially for the 1995–96 fiscal year. From July 1995 to February 1996, the average number of monthly recipients per county was $2,815—a 9.5-percent drop from the previous year.

[2] *Ibid.*, Table 2, pp. 3–4. Counties are responsible for 50 percent of the administrative costs for Medicaid and 5.2 percent of the payments to vendors.

[3] *Ibid.*, Table 3, pp. 5–6. Counties are responsible for 50 percent of the administrative costs for Food Stamps.

[4] State Bureau of Investigation, *Crime in North Carolina*, N.C. Department of Justice, Division of Criminal Information, Raleigh, p. 189 in 1992 edition, p. 223 in 1995 edition. Arrest data are for calendar years 1990 and 1994, not fiscal years. Violent crime index includes arrests for murder, rape, robbery, and aggravated assault. Property crime index includes arrests for burglary, larceny, and motor vehicle theft.

[5] Data from the N.C. Department of Public Instruction. Although public school attendance grew modestly statewide, many urban counties experienced substantial increases while some rural counties saw declines. For instance, membership increased 19.5-percent in Wake County, 19.0 percent in Dave County, 17.1 percent in Cabarrus County, and 11.6 percent in Mecklenburg County from 1990–91 to 1994–95. DPI projects that final average statewide daily membership will grow to 1,155,180 for the 1995–96 school year, a 2.1-percent increase from 1994–95.

Existing and Proposed Revenue Options for Local Government

Local Revenue Option	Number of Counties Currently Authorized to Use This Option
1. Property Tax	100
2. Local Option Sales Tax (up to 2 cents)	100
3. Hotel/Motel Occupancy Tax	66 counties, 33 municipalities
4. Land Transfer Tax	7 counties (Camden, Chowan, Currituck, Dare, Pasquotank, Perquimans, and Washington)
5. Amusement Tax	2 authorized, 1 implemented (Greensboro--implemented, Cabarrus County--authorized)
6. Prepared Food and Beverage Tax	4 counties and 2 cities (counties: Cumberland, Dare, Mecklenburg, and Wake; cities: Charlotte, Hillsborough)
7. Additional Local Option Sales Tax (above 2 cents)	0
8. Local income tax	0

Table 1. North Carolina Counties with the Highest Population Growth in the 1980s and Their Projected Growth in the 1990s

Rank / County		Population Change 1980's (actual)	Population Change 1990s (projected)
1.	Dare	+70.0	+42.5
2.	Brunswick	+42.5	+28.1
3.	Wake	+40.5	+29.7
4.	Onslow	+32.9	+15.9
5.	Pender	+29.6	+23.9
6.	Carteret	+27.9	+19.1
7.	Mecklenburg	+26.5	+23.1
8.	Currituck	+23.9	+19.3
9.	Orange	+21.8	+18.8
10.	Franklin	+21.2	+19.7
11.	Pitt	+19.7	+18.6
12.	Union	+19.6	+18.4
13.	Durham	+19.4	+19.2
14.	Lincoln	+18.8	+16.3
15.	Henderson	+18.3	+13.5
16.	Moore	+16.8	+11.9
17.	Randolph	+16.7	+14.4
18.	Watauga	+16.7	+7.4
19.	Macon	+16.5	+11.2
20.	New Hanover	+16.2	+12.0

Source: Sheron K. Morgan and P. William Tillman Jr., *Population Projections: 1991–2020, North Carolina and Its Counties*, N.C. Office of State Planning, July 1992, pp. 14–17.

Table 1. Key Arguments For and Against a Tax Menu for Local Governments

Pros of a Tax Menu

1. Towns and counties could tailor their tax structure to the strengths of the local economy.
2. Many menu items already are in place in some cities and counties.
3. Granting additional flexibility would be consistent with the trend toward returning authority to the local level.
4. Local government is closest to the people so that voters can more easily hold elected officials accountable for taxing decisions.
5. Political constraints work against using property tax increases to meet rising service demands.
6. In lieu of raising the property tax, cities and counties are turning to user fees that are more regressive than the menu items in the way they distribute the tax burden.

Cons of a Tax Menu

1. Some of the menu items—such as the meals tax, the hotel/motel tax, the amusements tax, and the land transfer tax—would not help some of the less populated and poorer rural counties that need help most.
2. The meals tax, the hotel/motel tax, the amusements tax, and the land transfer tax target specific industries or types of businesses, which raises a fairness issue.
3. Some of the menu items—such as the local option sales tax—are regressive and would shift the tax burden away from wealthy individuals and businesses with large amounts of property.
4. The menu gives local officials additional authority to raise taxes at the local level, which flies in the face of anti-tax sentiments.
5. The state may be less willing to share revenue with local governments if it grants additional taxing authority, which could hurt poorer towns and counties that have fewer resources to tax.
6. Local officials already have broad constitutional authority to raise property taxes to meet their revenue needs.