The Tennessee Advisory Commission on Intergovernmental Relations

Suite 508
226 Capitol Blvd. Building
Nashville, TN 37243-0760
Phone: (615) 741-3012
Fax: (615) 532-2443
www.tn.gov/tacir

MEMORANDUM

TO: TACIR Commission Members

FROM: Harry A. Green
Executive Director

DATE: December 9, 2009

SUBJECT: Draft Report on County Revenue Partnership Fund

The draft report is in response to Public Chapter No. 1057 of 2008. PC 1057 of 2008 created a separate account within the state general fund known as the "County Revenue Partnership Fund." Beginning in fiscal year 2009-2010, the act allows the General Assembly to make a specific dollar appropriation to the fund from the portion of the state sales tax earmarked and allocated specifically to the state general fund. Any such appropriation cannot exceed the amount shared with municipalities from the state sales tax in the previous year. Any funds appropriated to the fund are to be distributed on a population basis. The act mandates that TACIR study and evaluate the provisions of this act and related policy matters and report its findings and recommendations by June 30, 2010.

TACIR DRAFT REPORT (11/11/2009)

COUNTY REVENUE PARTNERSHIP FUND

Introduction

Public Chapter No. 1057 of 2008 creates a separate fund (County Revenue Partnership Fund) within the state general fund to be distributed to county and metropolitan governments (Nashville-Davidson County, Lynchburg-Moore County, and Hartsville-Trousdale County). Funding is to come from specific appropriations from the portion of state sales tax revenue identified at TCA 67-6-103 (a) (1).[1] As a result, any specific dollar appropriation made by the Legislature to the newly created fund would not impact funds specifically earmarked for education (TCA 67-6-103(a)(2)), municipalities (TCA 67-6-103 (a)(3)), the Department of Revenue (TCA 67-6-103(a)(4)), or the state sinking fund (TCA 67-6-103(a)(5)).

The Legislature may make a specific dollar appropriation to the newly authorized fund beginning in any year after fiscal year 2008-2009. The appropriation in any year can not exceed the amount appropriated in the previous fiscal year to municipalities pursuant to TCA 67-6-103(a)(3)(A). Estimated municipal fund distributions (from state sales tax collections) during fiscal year 2008-2009 are $257 million.[2] Distributions from the County Revenue Partnership Fund are to be made monthly on the basis of population.

The Legislature has made only one appropriation to the CRPF since passage of the law. In the general appropriations act for 2009-2010, a portion of $1,200,000 appropriated to the state as its share of the local costs of implementing SB 2357/HB 2389 is to be distributed to the CRPF. The Commissioner of Finance and Administration will determine the amount that is to assist in funding the local cost of various children's services and mental health.

Public Chapter No. 1057 requires the Tennessee Advisory Commission on Intergovernmental Relations to study and evaluate the new law and report its findings and recommendations by June 30, 2010.[3]

[1] TCA 67-6-103 establishes the distribution of state sales tax collections. TCA 67-6-103(a) (1) refers to the sales tax apportionment to the general fund (unearmarked portion).
[2] *State of Tennessee, The Budget for Fiscal Year 2009-2010*, page 92.
[3] Public Chapter 1057 of 2008 provides that "The Tennessee advisory commission on intergovernmental relations shall thoroughly study and evaluate the provisions of this act and related policy matters and shall report its findings and recommendations to the finance, ways and means committee of the senate and the house of representatives on or before June 30, 2010."

Existing State Intergovernmental Aid to Cities and Counties

In fiscal year 2007, state intergovernmental aid to Tennessee local governments was $6.2 billion.[4] A majority of this amount was in the form of restricted categorical aid or grants, with two-thirds (approximately $4.1 billion) representing state aid for elementary and secondary education (BEP). Only $541.1 million (less than 9%) was distributed to local governments in the form of unrestricted general support aid, primarily from various state tax sharing arrangements with cities and counties.

Previous reports by TACIR have detailed the many tax sharing arrangements through which portions of Tennessee state taxes are distributed back to local governments. These distributions are required through specific earmarking provisions in the law, some of which date back to the early 20th century. Thirteen state taxes are shared with local governments.[5] During fiscal year 2008, $828 million of state taxes were shared with local governments.[6] Approximately 60% of this amount went to municipalities and 40% to counties. The single largest distribution ($285.8 million) was from state gasoline and diesel fuel taxes (shared with counties and cities and earmarked for roads, highways, and bridges). The second largest distribution was from the state sales tax ($267 million), almost all of which was distributed to municipalities with no restrictions as to use.

State Sharing of Sales Taxes[7]

Existing law that requires the sharing of state sales tax revenue with municipalities dates back to the original state sales tax law (1947). When the state sales tax was first passed in 1947, it required that 12.5% (of the revenue generated by the original 2% state sales tax) be distributed to cities on the basis of population. The portion of state sales tax revenue earmarked for municipalities and the per capita basis for its distribution have not changed in over 60 years.[8]

The original sales tax legislation not only provided city governments with a portion of the 2% state sales tax (12.5 % of collections) but also provided, among other things:

- 70% (of total collections) be used for education, most of which, at the time, was provided by county governments, and

[4] Public use data for Tennessee state government available at http://www.census.gov/govs/www/state07.html; accessed on July 29, 2009. Comparable local data for 2007 will be available later in 2009.
[5] See TACIR (January 2004), p. VI.
[6] Data from the Tennessee Department of Revenue. Excludes distributions of the state 17% wholesale beer tax.
[7] What follows has been excerpted from a prior TACIR publication; see "State Tax Sharing, Fairness, and Local Government Finance in Tennessee," TACIR Staff Report, January 2004, p.14-15.
[8] The 12.5% share at the original 2% tax rate is approximately the same as the current 4.5925% share of a 5.5% state sales tax (1.5% of the current state tax rate of 7% is totally earmarked to education).

- that if revenue collections exceeded $20 million in any fiscal year, the excess was to be distributed 80% among the counties, 12.5 % among the cities on a population basis, and 7.5% to the Sinking Fund. The amounts distributed to counties were earmarked for education, aid to dependent children, aid to the blind, and for old age assistance.

Soon after the tax was levied, large "unanticipated" sales tax revenue began to flow into state coffers. The distribution of such "surplus" funds, primarily to counties soon generated some criticisms. Cries of an "unjust and indefensible situation" arose when studies showed that some rural areas were receiving (on an A.D.A. and per capita basis) ten times the amounts received by metropolitan areas.

Over time, as the state sales tax rate was raised, the statutory percent shared with cities has been reduced. This was done to insure that the additional revenue generated by tax rate increases themselves went to the state general fund (generally for education). However, the dollar amounts distributed to city governments have grown dramatically over the years. The municipal fund continues to be distributed, with a few exceptions, on the basis of population.[9] The appropriateness of a distribution based on population has been noted in prior TACIR publications on state tax sharing.

Since 2006 a minor amount of state sales tax revenue has been earmarked to certain county governments. This sharing with some county governments resulted from passage of the "Tennessee River Resort District Act."[10] The states sales tax amounts distributed to county governments as a result of this legislation and certain other exceptions in the law amounted to less than $3 million in FY 2009. These amounts do not impact the portion of the state sales tax earmarked for municipalities.[11]

Purpose of Legislation and Revenue Implications

The largest amount of shared tax revenue to counties currently comes from distributions of gasoline and diesel fuel tax collections. All these funds are restricted (earmarked) for use on roads, highways, and bridges. While restricted, such funds are partly fungible and clearly release some unrestricted local funds that otherwise would be used for roads and highways for use elsewhere.[12]

---

[9] The exceptions include Gatlinburg, Pigeon Forge, and several other locations that fall within the exceptions described at TCA 67-6-103(a)(3)(B) & (G).
[10] Public Acts 2005, Chapter No. 212.
[11] Any distributions made to Tennessee River Resort Districts are paid from the state general fund. Therefore, strictly speaking, the amounts received by counties as a result of the TRRD Act, while computed on the basis of state sales taxes collected in such districts, are not paid from state sales tax revenues.
[12] The 3 cent state gasoline tax increase in 1985 included some "maintenance of effort" requirements that somewhat reduced the fungibility of part of the restricted gasoline and diesel fuel tax distributions. However since six counties had a maintenance of effort requirement of $0 and several others had requirements of less than $100,000, these earmarked state funds were clearly partly to fully fungible.

The primary purpose of the legislation creating the County Revenue Partnership Fund is to facilitate a potential new source of unrestricted general fund revenue to counties similar to the unrestricted sales tax revenue shared with municipalities (4.59% of state sales tax revenue). While the legislation itself does not guarantee any new funds to counties, it does help position them in the future for consideration of an appropriation when state sales tax revenue improves. The existence of a special account that benefits counties will increase the likelihood in the future of appropriations to the account (CPRF) when and if state revenues finally recover from the protracted recession. The largest source of unrestricted shared revenue to counties now comes from distributions of TVA in lieu of tax payments (gross receipts tax payments).

The legislation capped any fiscal year appropriation to the CRPF to the amount of state sales taxes distributed to municipalities in the previous fiscal year. As worded, any significant apportionments to the CRPF (or to counties or specific counties) could result from some combination of:

1. substantial and probably unanticipated increases in state sales tax collections;
2. an increase in the state sales tax rate without the increase being fully earmarked for education use only;
3. significant broadening of the sales tax base to currently untaxed activities or products;
4. a significant change in the existing methods of sharing all state tax revenues with local governments to better reflect local responsibility, local fiscal effort, and local fiscal capacity.

Options

Substantial growth in state sales tax collections

It's not clear that this option (or turn of events) would provide county governments with significant new unrestricted revenue. Moreover, whatever distributions might be forthcoming from such a source will not represent a stable source of revenue. Such distributions are subject to specific appropriations and not automatic as are those resulting from specific tax-sharing distributions to municipalities. Therefore the level of funding in any given year is problematic.

Increase in State Sales Tax

In the current economic environment, an increase in the state sales tax rate to benefit primarily county governments is not likely. Eventually, the state will face increased fiscal pressure to replenish its operating revenues as well as its reserves. When that occurs, it is not likely that new programs or increased tax-sharing arrangements with county governments will be a priority. Therefore the requirement that appropriations to the CRPF come from the unrestricted sales tax distribution to the state's general fund makes it unlikely that any significant funding to the CRPF will be forthcoming any time soon.

Significant Broadening of the Sales tax Base to Currently Untaxed Activities or Products

If the sales tax is broadened to include more services not currently in the sales tax base, county governments would benefit in two ways. First, county government local sales tax revenue will increase as a result of the base broadening. This increase will depend heavily on the size of the service sector in the county. Since 50% of the new revenue must be used for education (regardless of where collected within the county), county governments may get some relief from this portion of any resulting sales tax increase. The distribution of the remaining 50% increase in sales tax revenue will depend on where in the county the newly taxed services occur.

Second, any increase in state sales tax revenue will increase all sales tax fund distributions, including the distribution to the unrestricted general fund account.[13] This increase may be used to apportion funds to the CRPF.

Change in Distribution Formulas

While a distribution method based on population is administratively simple, it does not reflect differences in local government responsibilities, local government fiscal capacity, or local government fiscal effort. The failure of most current state tax sharing arrangements in dealing with and reflecting the reality of very different local responsibilities and fiscal capacities has been identified in prior TACIR publications. These major weaknesses[14] in existing tax sharing arrangements include:

- distributions from the state sales tax to all municipalities based on population without regard to the types and level of local services provided;
- distributions to both cities and counties on a per capita basis even though in some cases the population data is distorted by prisoners, military personnel, and college students;
- distributions of any kind without regard to local fiscal capacity (in contrast to BEP grants that consider both required local services and local fiscal capacity);
- distributions from the hall income tax to local governments based on the residence (city area or county area) of the taxpayer without regard to the number of local services provided, the level of services provided, local tax effort, or local fiscal capacity;
- distribution of gasoline and diesel fuel tax collections made to local governments without any consideration of actual road usage (TACIR: February 2005, pp.2-7);

---

[13] Unless the new revenue can be identified and is specifically earmarked for other uses.
[14] For a fuller description of the major inequities found in tax sharing arrangements in Tennessee, see TACIR (January 2004), pp. 80-85.

- special distributions to certain resort cities without regard to the level of local taxes generated from non-residents who visit such resort locations (TACIR September 2004, pp.44-48);
- none of the existing tax-sharing arrangements with cities and counties reflects any consideration of which level of government provides each service and the level of service provided (TACIR 2006);
- existing tax sharing distributions are based on one or some combination of the following: (1) population, (2) land area, (3) situs of collection or taxpayer residence,[15] and (4) simple equal shares (see TACIR 2000, pp. 12-13);
- an almost blind attachment to historically-based criteria some of which are over seventy years old;
- a never-ending political response to change by attempting to hold all parties harmless by grandfathering-in all parties that might be negatively affected by a distribution change even if the change is related to ongoing changes in the economic environment in which we live.

Distribution Options that Reflect Actual Local Service Responsibilities and Local Fiscal Capacity

One might guess from the title of this section that this topic had never before been considered or discussed. In fact, it represents the two major considerations that drive Tennessee's Basic Education Program (since funding began in FY1992-93);

1. calculate the cost of a reasonable K-12 education program in each school district,[16] and
2. calculate a measure of the fiscal capacity of each district, convert the estimate to a relative index or measure of capacity (vis-à-vis other school districts), then calculate each school districts share of its local program, with the balance financed with state aid. Poor districts generally pay a smaller share of their program costs than wealthier (measured by fiscal capacity) school districts.

Tennessee's education equalization program took years to develop and finance, but the equalization finance program (and its progeny BEP II) is now almost 19 years old, hardly a new concept. What is somewhat new is the concept of sharing state tax dollars with local governments using the same or similar methodology. While certainly an interesting political and administrative challenge, a broad outline of an equalization program for sharing state taxes with local governments (for non-education purposes) was ably described by Reschovsky (2002)[17] for consideration in Wisconsin:

1. …."the starting point is to define a package of basic services and to determine the minimum amount of money that will be required to deliver these services in each municipality."[18]

[15] Also known as a "return to origin" basis.
[16] In Tennessee, this includes county, city, and special school districts.
[17] Reschovsky (2002), p. 11.
[18] In Wisconsin, a major portion of local services are delivered by municipalities.

2. …"The second element is to determine the amount of fiscal effort that each municipality must make. The actual dollar contribution that each local government must make toward financing "Badger Basics" will then depend upon the size of its property tax base."[19]
3. "Those municipalities where the cost of providing the package of basic services exceeds the required local contribution would receive a shared revenue payment equal to the difference between the cost of basic services and required local revenues."

Implications of such a program in Tennessee:

- Municipalities that do not provide significant services would not likely receive any funds;
- Municipalities that do not impose property taxes or impose low property taxes would not likely receive much in shared taxes;
- Counties that have a large portion of their citizens residing in cities that provide many local services will not receive as much funding as counties that provide all of most of the public services provided within the county;
- The cost of providing government services varies from location to location. Distributions formulas can be adjusted to reflect cost differences in the provision of public services;[20]
- For success, the state government must avoid maintaining prior shared tax levels through various "hold harmless" provisions that only serve to perpetuate poorly designed distributions of the past;
- A new tax-sharing arrangement can include a minimum per capita amount of aid to "help bring everyone to the table" or a reasonable transition period during which time the "new" method supplants the "old" methods.

State Tax Sharing Arrangements in Other States

There is no one-stop-statistical-shopping site for information on how states that share tax revenues with local governments actually distribute such funds.[21] However prior surveys generally reflected distribution methods similar to those currently in use in Tennessee; namely historical-based methods including criteria such as (1) situs of tax collections, (2) population, and (3) road miles. A few states have formally recognized the limitations of their existing distribution schemes in addressing the issues of local fiscal imbalances.[22] A

[19] "Badger Basics' refers to the package of basic services that each local government is expected to provide. The property tax reference reflects the fact that property taxes are the primary source of local revenue in Wisconsin.
[20] Bradberry (2007, p. 22) notes the "We find that communities with greater population density, number of commuters, population size, unemployment, and poverty have to spend more per capita to provide a standard bundle of municipal services; that is, they have higher uncontrollable costs."
[21] See Zelio (2006).
[22] Fiscal imbalance is intended to refer to the problem of short and long run disconnects between government service responsibilities (actual or promised) and the revenue needed to finance such

few states have actually implemented tax-sharing programs that consider local non-school service needs and local fiscal capacity in their tax sharing arrangements. [23] Despite the fact that most states now provide equalization funds to local governments to insure a more equitable distribution of primary and secondary education services, the same logic and reasonableness that drives equalization funds for education has not been embraced by states in guiding distribution of non-school aid to local governments.

---

responsibilities. Tennessee's BEP funding is an example of a state program that recognizes that there was a fundamental disconnect in some counties between the cost of a reasonable level of education services and the county's ability to fund those services.

[23] Minnesota instituted a new LGA (local government aid) program in 2003 that considers "need" and "ability to raise local revenues." In the past, Massachusetts distributed unrestricted local aid based on a similar design (no longer used).

BIBLIOGRAPHY

Andrew Reschovsky. 2002. *Wisconsin's local government finance; a policy primer*, Robert M. La Follette School of Public Affairs, November 2002.http://www.lafollette.wisc.edu/publications/otherpublications/wisconsinprimer/2002/MunicipalPrimer2002.pdf, (accessed July 17, 2009).

Bradbury, Katharine and Bo Zhao. 2009. "Measuring non-school fiscal disparities among municipalities". *National Tax Journal* LXII, No.1 (March 2009): 25-56.

ECONorthwest. 2007. *Highway cost allocation study, 2007-2009 biennium.* Prepared for Oregon Department of Administrative Services, Office of Economic Analysis. http://www.oregon.gov/DAS/OEA/docs/highwaycost/2007report.pdf (accessed on July 19, 2009).

Olin, Rick.2005. *Shared revenue program (county and municipal aid and utility aid).* Wisconsin Legislative Fiscal Bureau, Informational Paper 18. January, 2005.

Property Tax Study Project. 2001. "Aid distribution formulas." *Tax Facts, a newsletter of the Property Tax Study Project.* January/February 2001. Minnesota.

Research Department, Minnesota House of Representatives. 2003. *Fungibility of local government revenue sources.* Letter to House committee on Taxes. February 24, 2003. http://www.house.leg.state.mn.us/hrd/issinfo/funglgr.pdf (accessed on July 19, 2009).

TACIR. 2000. *State shared taxes in Tennessee.* Staff Report. Nashville, TN: March 2000.

TACIR. 2004. *Hall income tax distributions and local government finances.* Staff Report. Nashville, TN: April 2004.

TACIR. 2004. *State tax sharing with cities: the case of premiere type tourist resort cities as models.* Staff Report. Nashville, TN: September 2004.

TACIR. 2004. *State tax sharing, fairness, and local government finance in Tennessee*. Staff Report. Nashville, TN: January 2004.

TACIR. 2004. *State-shared taxes and cities without property taxes: A source of inequity? S*taff Report. Nashville, TN: September 2004.

TACIR. 2005. *State highway aid to local government in Tennessee.* Staff Information Report. Nashville, TN: February 2005.

TACIR. 2006. *Identifying and measuring local government service level differences for county governments: the missing element in fiscal capacity/fiscal need studies.* Unpublished staff report. Nashville, TN.

Zelio, Judy. 2006. "State aid to local governments." *Legisbrief, National* Conference of State Legislatures. Vol.14, No. 36, August/September 2006.

Zhao, Bo and Katharine Bradley. 2008. *Designing state aid formulas: the case of a new formula for distributing municipal aid in Massachusetts.* Federal Reserve Bank of Boston, Research Department Working Papers. No. 08-1, April 28, 2008.