Local Government Finance in Kentucky: Time for Reform?

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This is a time of increased interest in local government finance in Kentucky, as evidenced by the creation of a Task Force on Local Taxation, established by the General Assembly. The final report of the Task Force offers significant recommendations, including an amendment of the state constitution that would provide the General Assembly with the flexibility to institute new sources of local revenues. The present paper reviews the status of local government finance in Kentucky and discusses some of the key findings and recommendations of the Task Force. As the Task Force report clearly recognizes, informed analysis of local tax policy in Kentucky is hampered by inadequate data on local government finances. This paper identifies some of these deficiencies, as well as a number of important policy issues that require further policy analysis, particularly if the General Assembly entertains significant reforms of local taxation.

1. Introduction

As all Kentuckians are aware, tax reform in the Commonwealth has been the focus of concerted attention in the past few years. We have already seen significant modifications of the state's tax structure, including such noteworthy changes as the elimination of the corporation license tax. Possible reform of local government taxation is now on the agenda: a Tax Force on Local Taxation, established in 2005 by House Bill 272, has devoted a year of effort to the study of local tax issues and has recently (June, 2006) issued its final report. What are some of the concerns that have prompted this examination of local government finance? What has the Task Force proposed? What issues require further analysis? The issuance of the Task Force report makes this an opportune time to review the status of local government finance in Kentucky, to examine the findings and recommendations of the Task Force, and to consider some of the policy options facing the citizens of the Commonwealth. These are the goals of the present paper.

Because of the complexity of local government structure and financing, Section 2 begins with a concise overview of the system of local government finance in Kentucky. This system is an outgrowth of a body of constitutional and statutory control and regulation of local governments which define the taxing powers of these units of government. Section 3 describes the most important of these constraints and discusses some of their possible effects. With this background, Section 4 turns to a review the Task Force report. Section 5 concludes.

2. Local Government Structure and Finance in Kentucky and the Nation

As is true in many states, the system of local government finance in Kentucky is a somewhat intricate affair. There are many types of local governments, performing an extraordinary variety of tasks, and deriving revenues from many diverse sources. The great British economist Alfred Marshall is purported to have said that "all short statements about economics, with the possible exception of this, are false;" the same can certainly be said about local government finance. Still, it is important to see the forest for the trees. At the risk of some oversimplification, this section begins with a review of some of the key elements of local government structure and finance in Kentucky and relates these to the rest of the nation.[1]

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2.1 Structure and Financing of Local Government in Kentucky: A Concise Summary

Types of Local Governments. First, it is important to realize that there are many different types of local government in Kentucky, as in all states. Of greatest importance are Kentucky's counties, municipalities, school districts, and "special districts."

Kentucky is a "county-rich" state: its 120 counties, serving a population of just 4.1 million, have a mean population of only about 35,000. There are several large counties, and these contain a large fraction of the state's total population; the remainder thus have quite modest numbers of residents. (By way of contrast, the state of California has only about half as many counties (58), with a total state population of about 36.1 million – over 600,000 residents per county.) Counties play a particularly important role in providing public services outside of municipal boundaries, in regulating land use and development, and as administrative units of government.

Kentucky's 433 municipalities vary widely in size. They are grouped into 6 administrative classes, based mainly on population. Louisville/Jefferson County is the only city of the "first class" in the state. Cities with populations between 20,000 and 100,000 and Lexington/Fayette County, a total of 13 altogether, constitute the second class. There are 19 third class cities (8,000-20,000 population) and more than 100 cities each in the fourth, fifth, and sixth classes. The last of these classes consists of 176 cities with populations under 1,000. Municipalities are important providers of public services within their boundaries.

Public education services are provided by nearly 200 local school districts in Kentucky. To a much greater degree than other local units of government, school districts depend on state government financial assistance, which accounts for about half of aggregate school district revenues. This financial assistance is delivered through a complex formula system that presumably attempts to achieve some state educational policy goals, and a discussion of school district financing therefore quickly becomes entangled in issues of educational policy. These issues go beyond the scope of the present essay, which is limited to some general remarks about the overall structure of state/local financing for education and about the advantages and disadvantages of more or less decentralization of education finance. (For further discussion of school finance, see Wildasin (2001, pp. 90-101).)

Another important but very heterogeneous category of local governments in Kentucky are the so-called "special districts." These units, sometimes created as sub-entities of other localities, provide park, flood control, transportation, fire, emergency, sanitation, health, and other services. According to the 2002 Census of Governments, Kentucky has 720 special districts. This count, however, excludes numerous other agencies and authorities which, to some degree, fall under the control of other units of government but which also possess some degree of independent authority, including the authority to issue debt.

Revenue Sources for Local Governments. In general, local governments in Kentucky depend upon property taxes, "occupational license" taxes (imposed on the earnings of individuals and on the incomes of businesses), and taxes on insurance premiums as their principal sources of *tax* revenue. School districts derive revenues from taxes imposed on the gross receipts of utilities; as of 2005, this tax, formerly collected at the local level, is administered at the state level with proceeds transferred to school districts. Taxes on telecommunications, also previously imposed by local governments, are now collected at the state level as well, with revenues paid out to localities in amounts corresponding to previous local collections. Local governments also rely on various nontax sources of revenue and on transfers from the state government; the latter are particularly important for school districts.

The key features of this system of finance are readily summarized. In order to provide some quantitative perspective, Table 1 provides basic data on the financing of local government and of state and local government combined for Kentucky and for all state and local governments in the US for 2003-2004.

First, Kentucky has a relatively *centralized* system of finance: local governments raise only 40% of total state/local revenues, compared to the US average of 58%. In Kentucky, the state government is "large" relative to local governments.

Second, state aid to local governments in Kentucky is not markedly different from that in the rest of the nation: 44% of local government revenue derives from intergovernmental transfers, compared

TABLE 1: Level and Composition of State and Local Government Revenues, Kentucky and U.S., 2003-2004

(Dollar figures in thousands.)

Kentucky

Revenues, type	State & local government combined	Share of general revenue (%)	Share of own-source general revenue(%)	Share of tax revenue	Local government	Share of general revenue (%)	Share of own-source general revenue (%)	Share of tax revenue
General revenue	22,982,302	100%			9,184,914	100%		
Intergovernmental revenue	6,241,782	27%			4,030,875	44%		
From Federal Government					347,912	4%		
From State government					3,682,963	40%		
General revenue from own sources	16,740,520	73%	100%		5,154,039	56%	100%	
Taxes	11,460,494	50%	68%	100%	2,997,094	33%	58%	100%
Property	2,136,455			19%	1,680,995			56%
Sales and gross receipts	4,313,337			38%	307,030			10%
General sales	2,477,717			22%	11,684			0%
Selective sales	1,835,620			16%	295,346			10%
Motor fuel	476,605			4%	-			0%
Alcoholic beverage	79,104			1%	-			0%
Tobacco products	20,627			0%	-			0%
Public utilities	207,280			2%	207,280			7%
Other selective sales	1,052,004			9%	88,066			3%
Individual income	3,629,392			32%	809,999			27%
Corporate income	381,538			3%	-			0%
Motor vehicle license	207,904			2%	2,590			0%
Other taxes	791,868			7%	196,480			7%
Charges and misc. general revenue	5,280,026	23%	32%		2,156,945	23%	42%	

United States Total

Revenues, type	State & local government combined	Share of general revenue (%)	Share of own-source general revenue(%)	Share of tax revenue	Local government	Share of general revenue (%)	Share of own-source general revenue (%)	Share of tax revenue
General revenue	1,889,740,590	100%			1,094,729,372	100%		
Intergovernmental revenue	425,682,586	23%			430,114,245	39%		
From Federal Government					50,988,684	5%		
From State government					379,125,561	35%		
General revenue from own sources	1,464,058,004	77%	100%		664,615,127	61%	100%	
Taxes	1,010,277,275	53%	69%	100%	419,863,497	38%	63%	100%
Property	318,242,461			32%	307,528,431			73%
Sales and gross receipts	360,628,892			36%	67,303,155			16%
General sales	244,891,334			24%	46,942,486			11%
Selective sales	115,737,558			11%	20,360,669			5%
Motor fuel	34,943,572			3%	1,181,153			0%
Alcoholic beverage	4,985,706			0%	392,410			0%
Tobacco products	12,625,780			1%	322,515			0%
Public utilities	21,426,576			2%	10,717,400			3%
Other selective sales	41,755,924			4%	7,747,191			2%
Individual income	215,214,667			21%	18,959,532			5%
Corporate income	33,715,793			3%	3,486,756			1%
Motor vehicle license	18,708,983			2%	1,372,855			0%
Other taxes	63,766,479			6%	21,212,768			5%
Charges and misc. general revenue	453,780,729	24%	31%		244,751,630	22%	37%	

Source: Bureau of the Census

to 39% for the nation as a whole. As is true for other states, transfers from the Federal government are not a very substantial source of local government revenues in Kentucky.

Third, turning now to the composition of own-source revenues (i.e., revenues other than transfers from higher-level governments), note to begin with that Kentucky's localities depend heavily on nontax sources of revenue, which account for fully 42% of all local government own-source revenues. In this respect, Kentucky's localities are somewhat less tax-dependent than local governments elsewhere, which obtain 37% of their own-source revenues from nontax sources.

Fourth, property taxes are the most important source of tax revenue for localities in Kentucky, accounting for about 58% of all local taxes. This figure is much lower in Kentucky, however, than in the rest of the nation, where localities obtain almost three-fourths (73%) of their tax revenues from property taxes. Kentucky localities differ quite dramatically from those elsewhere in that they raise more than one-fourth (27%) of their tax revenues from "occupational license taxes," treated for Census purposes as a form of income tax. Note that general sales taxes account for significant amounts of local government revenues in the US as a whole. At present, localities in Kentucky are not permitted to utilize such taxes and therefore derive no revenues from them.

Local Taxation in Kentucky and the US. Putting some of these basic facts together, it is apparent that Kentucky's combined system of state and local government finance differs from the rest of the nation in two important and related respects. First, government revenues in Kentucky depend heavily on state-level taxation, with relatively little revenue derived from local governments. Secondly, Kentucky's fiscal system depends comparatively heavily on individual income taxation and is less property-tax dependent than other states. In fact, in their relative importance, individual income and property taxes in Kentucky are almost precisely an inversion of the national average: in Kentucky, property and income taxes account for 19% and 32%, respectively, of combined state/local tax revenues, whereas the corresponding figures for the nation are 32% and 21%. The extra share of income taxes in Kentucky arises entirely from local taxation: at the state government level alone, individual taxes account for 32% of total tax revenues both in Kentucky and for all state governments in the nation as a whole. This testifies to the important and rather unique role of "occupational license taxes' in local government finance in Kentucky.

In summary, compared to national averages, Kentucky's combined state/local fiscal system is "over-weighted" at the state level and "under-weighted" at the local level, and it is "over-weighted" toward income taxation and "under-weighted" toward property taxation, mainly because of the heavy dependence of localities on occupational license taxes. These characteristics of Kentucky's fiscal system are of long-standing and have been amply documented in other studies, including Boardman (2006), Hoyt (2001), Martie (2001), and Wildasin (2001).

2.2 Potential Structural Reforms

Differences between Kentucky's fiscal system and those found elsewhere in the nation provide no *a priori* indication that Kentucky's policies are better or worse than those found elsewhere. To begin with, policymakers and voters in different states and localities may select different policies because these jurisdictions differ in their economic structure, population characteristics, and other fundamental attributes. They may also have different policy preferences. And, finally, there is no magic formula that dictates what system of taxation is "best" for any one level of government or for a state and local fiscal system. Nevertheless, comparisons of fiscal systems can usefully highlight important distinctions and suggest potentially fruitful lines of analysis. They also indicate likely feasible (though not necessarily desirable) avenues of policy reform.

On the basis of the simple comparisons just provided, there is a reasonable presumption that Kentucky's localities could, if desired, assume greater responsibility for financing public services and that the state government could reduce the overall level of revenues that it collects. It is important to remember, however, that localities in Kentucky are no more heavily dependent on state government fiscal transfers than localities in other states, that is, the lower level of local revenue collection in Kentucky is accompanied by lower levels of local relative to state government expenditures. Thus, if Kentucky were to attempt to mimic the national average fiscal balance between state and local

governments, "decentralization" on the revenue side (increasing the weight of local relative to state taxes) would have to be accompanied by comparable decentralization on the expenditure side.

This immediately raises a fundamental issue, sometimes called "the assignment problem" in the literature of fiscal federalism: which government responsibilities are or should be assigned to each level of government? A rebalancing of state/local spending in Kentucky away from the state government would entail some shifting of expenditure responsibilities to local governments. Such a shift could take place in many ways, either by explicit transfer of functions from state to local governments or, more implicitly, simply by cutting state spending and leaving it to local governments to decide whether to increase local spending on the same or similar functions, to expand spending in other areas, or simply to maintain current local spending and functions, resulting in a net shrinkage of combined state and local spending (and taxation). A transfer of responsibility for the maintenance of certain roads from the state to county governments exemplifies the first option. The second option might be illustrated by a cutback in state spending on natural resources, public safety, or financial support for local school districts. Local governments are already actively involved in each of these functional areas and, if desired, could augment their spending in each in response to cutbacks in state services. In the absence of state mandates, the extent of any such adjustments would be left to the discretion of local governments and it is likely that different localities would respond in different ways, depending on individual circumstances and on the nature of the change in state government policy (Of course, all of these possible adjustments could occur in reverse if, initially, the state government *increases* its involvement in and spending on roads, natural resources, public safety, or elementary and secondary education.) From these remarks, it should be clear that reassignments of functions between state and local governments can certainly affect the levels of state and local taxation, but that such reassignments can also have many other important effects. In particular, changes in functional assignments involve the expenditure side of state and local government finance, first and foremost, while carrying important implications for the revenue side as well.

Closely related to the assignment problem is the issue of government structure. For instance, consider whether Kentucky should retain its "county-rich" organizational structure. Transportation and communication costs have fallen dramatically since most of Kentucky's counties were created in the period 1810-1830. It is possible that many counties could be usefully consolidated, thus, effectively, "reassigning upward" some of the functions now performed by counties with very small numbers of residents to new, larger county units. Conceivably, consolidated county governments, perhaps equipped with larger and more professional administrative staffs than can now be sustained, would be better able to manage complex tasks. They might therefore be better candidates for "downward reassignment" of some functions now performed at the state government level, allowing the state government to streamline its operations. This restructuring of county governments could thus facilitate a shift in the state's fiscal balance away from the state government and toward the local governments.

Of course, any such initiative would be a major undertaking and it is being discussed here mainly in order to illustrate the nature of the subtle and complex consequences that can follow from changes in government structure. A less dramatic reform that nonetheless raises similar issues of structure, functional assignment, and finances would be an overhaul of the system of special districts and other special public authorities in Kentucky. The numbers, functions, and financing of these special entities could either be expanded or contracted, allowing for growth or contraction of the local government sector as a whole or of a reconfiguration of responsibilities and funding among local governments. As discussed in Section 4, their status at present is quite murky because little information about their activities is readily available. A thorough inventory of these units of government and of their finances might motivate a serious reconsideration of their role in the system of local governance in Kentucky.

3. State Regulation of Local Taxation

As we have seen, local governments utilize a diverse array of revenue instruments, including property taxes, occupational license taxes, and nontax revenues and charges. All of these revenue instruments must comply with the fundamental constraints imposed by the state constitution as well

as with statutory controls imposed by legislative action. This section describes the main features of existing controls on local taxing powers.

The constitution recognizes the power of localities to tax property, subject to limits on maximum tax rates. In particular, Section 157 limits the maximum municipal tax rates to $0.75-$1.50 per dollar of assessed valuation depending (inversely) on city size, and to $0.50 per dollar of assessed valuation in all counties. In addition, under Section 181, the General Assembly may authorize localities to impose excise taxes and "license fees" on many "trades, occupations, and professions," providing the constitutional sanction for local occupational taxes and for taxes on insurance premiums. Section 181 is interpreted to preclude local sales taxes (LRC (2006b, p. 12)). It also specifically prevents the state from collecting taxes on behalf of local governments, which may preclude some types of "revenue sharing" arrangements, as discussed further below. The main statutory controls on local taxation pertain to property taxes and occupational license taxes. (Tax rates on insurance premiums are not limited by statute.) These constraints warrant further discussion.

HB44. Perhaps the best-known limitation on local taxation is House Bill 44 (HB44), enacted in 1979, which limits local property tax revenues for counties, cities, school districts, and special districts to a *rate of growth* of 4% annually.[2] This statute is sometimes claimed to have had a variety of effects, for good or ill. Presumably, its basic goal is to restrain local property taxation and, as we have seen, Kentucky is indeed a state with comparatively low levels of local property taxation. Whether Kentucky's below-average utilization of property taxes is attributable to the action of HB44 is very difficult to determine, however. It is true that property taxes played a somewhat less prominent role in local government finances after 1979. As reported in Boardman (2006, Table 1), county governments derived 29.8% of their revenues from property taxation in 1977, but only 22.3% in 1982. This percentage share has continued to fall over time and now only amounts to 12.5%. It should be noted, however, that county governments obtained 39.2% of their revenues from property taxes in 1972, which is to say that property tax revenues had already declined substantially in importance during the period 1972-1977, two years *prior* to the passage of HB44. For other units of government, as well, reliance on property taxation has fluctuated over time. Over the decade 1972-1982, city governments obtained about 20% of their revenue from property taxes, but this share has varied in the 12-14% range since that time. School districts obtained about 25% of their revenues from property taxes in 1972 and 1977. While this percentage fell markedly in 1982, to less than 15%, state government financial support for schools increased substantially at the same time. Since the early 1980s, school district dependence on local property taxes has risen, reaching almost 23% in 2002 – nearly equal to the 26% share of the pre-HB44 1970s. In short, the observed variations in reliance on property taxation during the period 1972-2002, by type of locality and over time, do not reveal any clear-cut effect that is readily attributable to HB44.

Of course, whatever its effects on aggregate levels of local property tax revenues, it is possible that HB44 has constrained property taxes for some specific localities at particular points in time. Unfortunately, direct evidence on this point is largely unavailable. HB44 has been in operation for more than a quarter century, during which time property valuation administrators for every county have filed documentation annually with state authorities certifying HB44 compliance for every local government within their counties. In principle, this documentation could have been compiled and published annually, providing a rich body of data on growth in property tax revenues, assessed valuations, and tax rates for all local governments in the state. In practice, it appears that no such compilation has taken place, and thus these data have been largely unavailable for the purposes of policy analysis and evaluation. The Task Force report (LRC (2006a, p. 4)) cites Wildasin (2001) (using data on county governments for 1998-2000) and the results of a 2005 survey of county governments by the County Judge Executives Association, both of which find that a minority of county governments are limited by HB44 constraints. There are apparently no other sources that report on the extent to which HB44 constraints have been binding on other types of local governments or for other periods of time. Thus, regrettably, the proximate effects of Kentucky's quarter-century experiment with property tax limitation are all but impossible to ascertain.[3] This is only one of several fundamental informational deficiencies that hamper the analysis of local taxation in Kentucky, as discussed in more detail below.

Note, however, that the effects of HB44, if they exist at all, may not necessarily take the form of binding constraints on local government property tax revenue. The *prospect* of limited growth in property tax revenues may have stimulated local governments to develop and utilize various other tax and non-tax sources of revenues that would otherwise have not been exploited. Furthermore, it is possible that the state government has offered more generous fiscal assistance to local governments during the past quarter-century because of concerns that local revenues would be unduly constrained by the operation of HB44. Finally, it is possible that HB44 has led to a proliferation of special districts which are not limited in the amount of property taxes they can collect at their inception since HB44 only constraints revenue growth relative to prior periods. For any or all of these reasons, the number of instances in which HB44 is strictly binding on local revenues in a given year may be rather small even though its impact on local government finance and local government structure may be important. Short of the development of a model of the fiscal interactions between state and local governments, there is no way to know whether this may be the case.

In summary, the fact that constraints on growth in property tax revenues appear not to be binding for most counties in recent years may justify a mild presumption that HB44 has had comparatively little effect on local governments and that its removal would therefore have rather modest consequences. In this case, HB44 adds complexity to state/local fiscal relations with little real benefit or harm. Beyond this, deficiencies in data and a lack of analytical effort imply that very little is known about the effects of HB44 on local government finances in Kentucky. For HB44 detractors and defenders alike, this is a highly unsatisfactory state of affairs, providing fertile ground for speculation but limited factual and analytical support for the preservation, removal, or modification of restrictions on local property taxes.

Occupational license taxes. Occupational license tax rates are also restricted by state statute for some units of government. In particular, school district occupational tax rates cannot exceed 0.5%, except for Jefferson County (Louisville), which may impose a rate as high as 0.75%. County governments may impose occupational taxes up to a rate of 1%, except for Louisville/Jefferson County for which special regulations apply. Municipalities generally are not restricted as to the tax rates they may impose.

To conclude this section, we have seen that local governments in Kentucky are subject to a somewhat complex set of limitations on their taxing powers. Their power to tax property is subject to constitutionally-imposed rate limitations as well as to HB44 limitations on the annual growth of property tax revenues. Comparatively few localities appear to be directly affected by these limitations, although they may have had important indirect effects by stimulating other sources of funding for local governments. Occupational license taxes are widely utilized by local governments. Cities are generally not limited in the license rates that they may apply, unlike counties and school districts. Local governments may also impose taxes on insurance premiums, at rates that are not subject to statutory limits. There are constitutional limitations on the ability of localities to impose general sales taxes, as well as on the ability of the state government to impose taxes on behalf of local governments.[4]

4. The Task Force Report

The Final Report of the Task Force on Local Taxation makes several recommendations. Its first and most important substantive recommendation concerns an amendment to Section 181 of the state constitution. As discussed above, this provision has been interpreted to limit the ability of local governments to impose general sales taxes and the ability of the state government to develop a system of revenue sharing with local governments. The Task Force report does not directly advocate the use of local sales taxes nor does it provide any specific recommendations regarding state-local revenue sharing; its recommendation is more limited in scope, merely proposing a constitutional amendment that would allow for the possibility of such reforms, should the legislature wish to consider them. A second focus of the Task Force report is the status of special districts: 4 of its 11 recommendations ask for better reporting by special districts and better monitoring of their fiscal affairs. Several other recommendations urge improved coordination between local governments and improvements in local tax administration. The Task Force also proposes the establishment of a "local government financial database" that would "provide relevant information about local government finances to decision makers," and, one might imagine, also to the public at large. It is clear from this

recommendation, and from those pertaining to special districts, that the deliberations of the Task Force were hampered by deficiencies in the existing systems for collection and reporting of information regarding local government finances. Let us consider the main Task Force recommendations and some of the policy issues that they raise.

Local Sales Taxation. The charge to the Task Force indicated that it should explore the possibility of local sales taxation as one method for "generating a comparable amount of local revenue," that is, as a potential replacement for local revenues now obtained from other sources. In a similar vein, the Task Force, in its recommendations, recognizes that if the General Assembly were to allow localities to impose sales taxes, it could also attempt to constrain the use of other local taxes so as to keep total local revenues at current levels. In practice, the introduction of the sales tax as a new revenue instrument for local governments could well result in increases in revenues for some localities, perhaps accompanied by decreases for others. The report does not discuss whether sales taxes would be used by counties, cities, school districts, special districts, or by some combination of all of these. If experience in other states can be used as a guide, a local sales tax would likely be utilized mainly by localities in the largest metropolitan areas in the state, as smaller governments would struggle with the administrative complexities associated with its implementation. Given the economic importance of the state's largest metropolitan areas, the introduction of such a tax could have a perceptible impact on aggregate local revenues which could, however, be offset by limiting other revenue sources.

If the local sales tax is viewed as a potential substitute for existing taxes, would it be used to reduce local property, income, or insurance premium taxes? The sales tax might be used to supplement or substitute for the insurance premium tax; both are levied on the revenues or sales of businesses, and thus share some administrative similarities, but of course the sales tax would be much broader in its application. On the other hand, because of its breadth and because taxes on earnings are (very) broadly similar in their economic effects to taxes on consumption, a local sales tax might be viewed as a substitute for local occupational license taxes. Localities differ, of course, in the extent to which their residents earn income or make purchases within their own boundaries. A locality with many residents that commute to places of employment in other jurisdictions may collect relatively little revenue from a tax on earnings, whereas major employment centers can derive significant revenues from the earnings of non-resident workers; similarly, jurisdictions with major shopping centers might use a local sales tax to obtain revenues generated by sales to non-residents as well as residents. For these reasons, a switch from local occupational to local sales taxes could have important differential revenue impacts across localities. As a third possibility, the introduction of local sales taxes could be accompanied by further restrictions on property taxation. The local sales tax differs quite substantially, both in administrative terms and in terms of its economic effects, from local property taxes.

The overall policy advantages or disadvantages of any of the above tax substitutions are not immediately apparent and cannot be ascertained without further analysis.[5] Presumably such analysis would underpin any future deliberations by the General Assembly, should Section 181 be amended to permit local sales taxes.

Revenue Sharing. The charge to the Task Force also specified that it should consider the desirability of revenue sharing for local governments, and the Task Force indeed recommends that Section 181 be amended in order to allow such policies. The form, magnitude, and purpose of such revenue sharing is little discussed in the Task Force report, however. The report expresses some concern that a revenue sharing system might result in reductions in local tax effort, stating that "any revenue sharing programs implemented should require a specified level of local effort before a local government is permitted to participate. … The concept is that local governments should help themselves before seeking assistance from Frankfort."

In principle, revenue sharing systems can be devised to serve a variety of different policy objectives. For instance, they can be used to overcome administrative hurdles to the use of certain taxes by lower-level governments. As an illustration, suppose that it were considered desirable to make the local occupational tax on individuals more like the state income tax by broadening its base to include nonwage income while simultaneously preserving exemptions, deductions, credits, and other special features commonly found in personal income taxes. Local governments might find it cumbersome to implement

such a tax, and it would impose nontrivial compliance costs on taxpayers. As an alternative, the state could share which each locality a portion of the income tax revenue that it derives from the taxpayers located there.

On the other hand, revenue sharing systems can be designed to advance quite different goals. For instance, HB44 or rate limits on local occupational taxes may constrain local revenues to an undesirable degree, perhaps leading local authorities to "seek assistance from Frankfort" in order to meet urgent expenditure needs. A system of state-local fiscal transfers could be devised that would put additional resources at the disposal of local authorities, based on some measure of fiscal need (e.g., inversely related to per capita income or assessed property valuation) or in accordance with some other criteria.

Designing a revenue sharing system that achieves its intended objectives is no simple matter, however. The Task Force recognizes that fiscal transfers to local governments may result in reductions in local taxes rather than increased funding for local services, effectively substituting state funding for local own-source revenues. The Task Force suggests that such transfers can be conditioned on local fiscal effort, for instance by requiring localities to utilize their local property taxes up to some specified levels. It is also possible to devise revenue sharing formulae that provide additional funding for localities that display high levels of tax effort. In practice, however, it is difficult to prevent the erosion of local own-source revenues, and the attempt to do so can easily give rise to very complex monitoring and enforcement requirements. For example, suppose that localities maintain their property tax collections in order to comply with revenue-sharing regulations while simultaneously reducing their use of charges, fees, and other nontax revenue sources. In this case, the net effect of revenue sharing transfers from the state to recipient localities would be to replace local nontax revenues by state government revenues. As is evident from Table 1, local governments in Kentucky derive more revenue from such nontax sources than they do from property taxation, so there is ample scope for localities to reduce their overall revenue-raising efforts while maintaining or even increasing property tax revenues. In an attempt to maintain overall fiscal effort, therefore, the state might be led to monitor and regulate local use of nontax revenues in addition to property or other major taxes. The ensuing magnification of state control over the details of local finance and policies would likely entail a substantial loss of local fiscal and policy autonomy, substantial administrative complexity and cost, and reduced overall responsiveness of local fiscal policies to the demands of local residents.

The prospect of such a policy evolution highlights the importance of achieving the utmost clarity in the formulation of fundamental policy objectives and of using the simplest and most direct methods to achieve them. For instance, if localities are perceived to have insufficient revenues at their disposal, it is crucial to determine why this should be the case. Local revenue inadequacy might result from the operation of state government limitations on local taxing powers such as HB44, in which case deregulation of local taxes may be a more transparent and effective policy option than the creation of a revenue sharing system, with its associated new body of regulatory constraints. On the other hand, revenue insufficiency may be important mainly for a subset of localities, distinguished by type (county, municipal), by levels of income or development, or by size. Clear identification of underlying policy concerns is critically important for the design and implementation of effective reforms.

As the foregoing remarks indicate, revenue sharing systems can be developed for many different policy purposes – to allow recipient governments to utilize new revenue sources with minimum administrative complexity, to transfer resources to lower-level governments with high fiscal "needs," to shift the overall burden of financing state and local government away from the latter and toward the former, or for any number of other reasons. The optimal design of a revenue sharing system depends crucially on the policy objectives it is intended to achieve. If Section 181 is amended to allow the introduction of some form of revenue sharing, the important task of defining the purposes of such a program and the examination of alternative means to those ends still lies ahead.

Special Districts and Compilation of Local Fiscal Data. As attested by the reliance of the Task Force and other analysts on US Census data, and as already indicated by some of the preceding discussion, the state of Kentucky has not as yet developed an adequate system for the compilation and reporting of data on local government finances. The situation regarding special districts, public authorities, and

other special governmental entities is particularly problematic. Theoretically, every unit of government in the state is supposed to file an annual uniform financial information report (UFIR), but testimony before the Task Force indicated that compliance with this requirement is poor. At present, it appears that there is no reliable and comprehensive compilation that identifies these governmental units and that can be used to analyze their revenues, expenditures, borrowing, or other financial and fiscal data. Under these circumstances, the Task Force was unable to examine in any systematic way the role of these governmental entities in Kentucky's fiscal system.

This situation can be remedied relatively easily and at modest cost, as the Task Force has recommended. Until this is done, policy analysis and evaluation is undermined and the state is exposed to potentially significant financial risks. To gauge the kinds of risks that may be involved, consider the findings of a study by Bridges (2005), which attempts to gather data on borrowing by public authorities in several metropolitan areas in Kentucky. This study examines six large jurisdictions (Jefferson and Fayette counties, Bowling Green, Florence, Owensboro, and Paducah) and finds that special public authorities within some of these jurisdictions account for 80% or more of total local indebtedness. Information about this borrowing is not readily available to the public, and thus the residents of localities in the Commonwealth may be exposed to significant liabilities associated with the activities of public authorities of which they are unaware.

More generally, as noted already in connection with HB44, there is a dearth of information regarding local fiscal policies in Kentucky. It is often argued that local governments, being "closer to the people," can be monitored and controlled relatively easily by their residents, creating a presumption that they are more responsive to local demands than higher-level governments. This basic perspective, articulated in a classic paper by Tiebout (1956) and developed in an extensive literature for the past half century, is based partly on the presumed public availability of information about local policies. In the absence of such information, local governments may be "captured" by interest groups or may simply fail to perform in accordance with the demands of local residents.[6]

The absence of adequate data regarding local finances undoubtedly limited the scope of Task Force activities. The establishment of a special Task Force to examine local finances is an unusual event, and it is a pity that the Commonwealth has missed an exceptional opportunity for a more thorough investigation of important policy issues due to the poor quality of local financial and fiscal data. Future policy deliberations can be significantly enhanced by the development of modern financial reporting systems for all local governments within the state, including regular and transparent publication of fiscal data for public use.

5. Conclusion

The Task Force on Local Taxation has touched upon several important issues and has left others for future discussion and analysis. Its recommendations for constitutional amendments highlight the desirability of enhanced flexibility for the General Assembly to introduce new financing options for local governments. The Task Force report does not, however, examine the potential desirability of enhanced flexibility for local taxation within the existing constitutional boundaries. In particular, it recognizes the potential importance of HB44 restrictions on local property taxation but does not seriously consider the potential advantages, in the form of increased local revenue autonomy, that might flow from the relaxation or removal of these restrictions. The Task Force report also has little to say about statutory limitations on local occupational tax rates. There may be sound reasons for states to impose limits on local taxes, although the competitive pressures under which localities operate also constrain local taxation even in the absence of statutory restraints. But, in any event, a review and reconsideration of the specific types local tax limitations in Kentucky is in order. For instance, after more than 25 years of HB44 property tax limitations, is there any basis for a presumption that a limit of 4% annual growth in property tax revenues serves public interests better than a limit of 3%, 5% or no limit at all? Is there a persuasive justification for limits on occupational tax rates for counties and school districts but not for municipalities? On what basis can the present limits on occupational tax rates be justified? In the absence of careful review and analysis, predicated on the availability of underlying

fiscal data, the present system appears to be somewhat haphazard in design and it effects, largely unknown.

The Task Force identifies serious limitations in the availability of basic information concerning local government finances and recommends that these deficiencies be remedied. Especially given the current state of data management technologies, the cost of these remedies is modest and the benefits – to policymakers, to analysts, and, above all, to the general public – are great. If these recommendations are implemented, researchers and analysts, both within the public sector as well as outside, will be able to shed significant new light on local fiscal policies and their impacts. This information would be of great value in future deliberations regarding the possible introduction of local sales taxation, revenue sharing, or other policy options. In addition, better data on local finances can assist in the monitoring and control of borrowing and financial management by special districts and public authorities, thus reducing financial risks for the Commonwealth's fiscal system as a whole and perhaps reaping some benefits in the form of reduced borrowing costs as well.

The development of local government finances in Kentucky is still a work in progress. Major policy issues regarding government structure, the assignment of functional responsibilities among levels of government, and the proper sphere of local revenue autonomy await further analysis. If the recommendations of the Task Force are followed, these issues will soon command the attention of policymakers and the public. Immediate improvements in data and support for significant analytical work can help to provide a foundation for more informed evaluation of the policy options that are likely to arise.

Endnotes

1. Several studies and reports may be consulted by readers seeking more detailed information about local government finance in Kentucky. Hoyt (2001) and Boardmand (2006) have contributed important treatments of this subject in previous issues of the *Kentucky Annual Economic Report.* In connection with the work of the Task Force on Local Taxation, the Legislative Research Commission (LRC) (n.d., 2006a) has prepared very informative surveys and reviews of local taxation, including much more detail than is provided below concerning the laws regulating local government finance. Wildasin (2001) also reviews local government finance issues in Kentucky. All of these studies also contain references to additional sources of information on this subject.
2. For the sake of simplification, this discussion omits some of the technical details of HB44 and other regulations governing local taxation. For more discussion, see, e.g., Wildasin (2001) and LRC (n.d., 2006a). It should be explicitly noted that the voters in any locality always have the prerogative, through special referenda, to approve revenue growth in excess of the 4% limit.
3. Assuming that annual PVA documentation has been preserved, it would likely be possible, at comparatively modest cost, to compile these data and thus to provide a meaningful foundation for the evaluation of HB44's impact.
4. It should be noted, however, that the recent state tax reform transferred the responsibility for the collection of taxes on telecommunications services from localities to the state government, with the revenues to be distributed to the localities in accordance with their previous levels of collections. Although this arrangement presumably conforms with Section 181 of the constitution, it could be characterized as a system of state collection of revenues on behalf of local governments.
5. In weighing the attractiveness of possible tax substitution reforms, it is important to consider interactions between the Federal and state tax systems. Local occupational and property taxes are generally deductible for purposes of Federal personal income taxation, reducing the net burden of these taxes, while the deductibility of sales taxes has varied substantially over time. In the absence of deductibility, sales taxation is less appealing.
6. Other local revenue instruments, such as tax increment financing or selective local economic development incentives, should also be transparently reported so that citizens can monitor their use and so that their impacts may be assessed.

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