

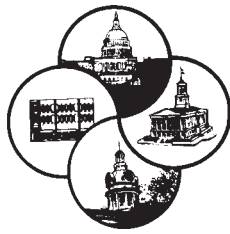
# STATE TAX SHARING, FAIRNESS, AND LOCAL GOVERNMENT FINANCE IN TENNESSEE



TENNESSEE ADVISORY COMMISSION  
ON INTERGOVERNMENTAL RELATIONS



STAFF REPORT  
JANUARY 2004



# TACIR Publication Policy

---

Staff Information Reports, Staff Briefs, Staff Technical Reports and Staff Working Papers and TACIR Fast Facts are issued to promote the mission and objectives of the Commission. These reports are intended to share information and research findings relevant to important public policy issues in an attempt to promote wider understanding.

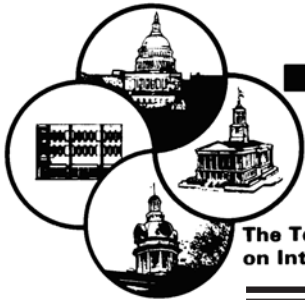
Only reports clearly labeled as “Commission Reports” represent the official position of the Commission. Others are informational.

**The Tennessee Advisory Commission on Intergovernmental Relations**

226 Capitol Boulevard Building • Suite 508 • Nashville, Tennessee 37243

Phone: 615.741.3012 • Fax: 615.532.2443

E-mail: [tacir@state.tn.us](mailto:tacir@state.tn.us) • Website: [www.state.tn.us/tacir](http://www.state.tn.us/tacir)



# TACIR

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



January 30, 2004

The Honorable John S. Wilder  
Speaker of the Senate  
The Honorable Jimmy Naifeh  
Speaker of the House of Representatives  
and  
Members of the General Assembly  
State Capitol  
Nashville, TN 37243

Ladies and Gentlemen:

Transmitted herewith is a report about state-tax sharing with city and county governments in Tennessee. This report examines each of the taxes that are shared and addresses the fairness of existing formulas used to distribute funds among city and county governments.

This report was requested by the Speaker of the House of Representatives. During the last five years, the Tennessee state budget crises has forced the General Assembly to examine state-shared taxes as a source to help balance the State's annual budget. Last year a crisis in budget agreement created a dispute about state-shared taxes, and more particularly the Hall Income Tax.

Many issues are raised by this report and we encourage each of you to examine it thoroughly. Beginning in June 2004, the Commission will begin a series of public hearings to allow all interested parties in the State to address the issues raised. It is hoped that this process will evolve into a set of recommendations to present to the General Assembly in 2005.

Respectfully Submitted,

Representative Randy Rinks  
Chairman

Harry A. Green, Ph.D.  
Executive Director

# **STATE TAX SHARING, FAIRNESS, AND LOCAL GOVERNMENT FINANCE IN TENNESSEE**



## **A TACIR STAFF REPORT TO THE GENERAL ASSEMBLY OF THE STATE OF TENNESSEE**

Harry A. Green, Ph.D.  
Executive Director  
Tennessee Advisory Commission  
on Intergovernmental Relations



# IN MEMORIAM

John T. Bragg

(1918-2004)



John Bragg spent most of his public service years working in the area of state budgeting and state-local finance. He served as Chairman of the House Finance Ways and Means Committee for 23 years, and he served as Chairman of the Tennessee Advisory Commission on Intergovernmental Relations from 1979 to 1996.

This report on state-shared taxes is respectfully dedicated to his great work. His memory will reside forever in those who knew him and loved him. He was truly a man for all seasons.

“Whenever the General Assembly did something for cities during one session, we always tried to do something for the counties in the next session.”

— John T. Bragg  
Former Chairman, House  
Finance Ways and Means  
Committee  
Former Chairman, TACIR  
(On the subject of how state  
tax-sharing evolved.)

# FOREWORD

This study was initiated by a request from the Speaker of the House of Representatives to study fairness in state-shared taxes. This comes at an historic time in Tennessee as policy leaders evaluate the fiscal underpinning of state and local governments. Over the past 5 years there has been considerable anguish and debate on tax reform, fiscal adequacy, and the appropriate fiscal relationship with local governments. For each of the past five legislative sessions, state-shared taxes, in total or part, have been viewed as a solution (or partial solution) to balancing the state budget. Since state-shared taxes are a critical component for funding services in Tennessee, a serious evaluation of goals and purpose is needed.

One of the critical issues in a study such as this is the availability of relevant and reliable data. In the field of public finance, this is always a challenge.

The fundamental database used for the analyses in this report is the U.S. Census of Governments for 1997 (COG 97). The Census of Governments results in a detailed collection of administrative, fiscal, and employment data gathered from surveys sent to every county, city, town, and special district in the United States at 5 year intervals. However, all survey responses are voluntary and as a result, some government units may not respond, and some that do, do not respond to all questions contained in the survey. Also, there is no way to verify the accuracy of the data and so it has to be accepted at face value. Because of time and money constraints, the U. S. Census has a limited ability to find and correct errors. The response rate over all was very good.

This explanation is provided as a warning to the reader that no analysis can be completely correct based on a database with such flaws. Nonetheless, this is the best data (although old) that exists to perform the charge that has been given to TACIR.

Any local government that believes the data is incorrect or inaccurate is encouraged to come forward and report correct and accurate data for their community.

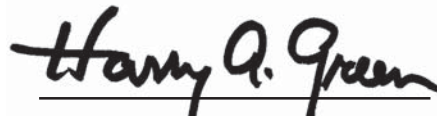
All in all, the TACIR staff believes that the quality of the data is very good and that conclusions drawn from the data are

reasonably accurate. One hoped for result of this study is a recognition of the need for better and more current data on local government finance in Tennessee.

At its January 2004 meeting, the Tennessee Advisory Commission on Intergovernmental Relations (TACIR) reviewed and discussed this staff report on state-shared taxes as a first phase of a comprehensive process of evaluating the fiscal interaction of state and local governments in Tennessee.

Additionally, the Commission decided on a course of action for phase two of the study. Beginning in June 2004, the Commission will conduct public hearings on all relevant issues involving state-tax sharing, including fairness in formula distributions as well as addressing other policy goals for state-shared taxes.

As indicated this is a first-phase report and is not purported to be complete. Likewise, not every issue that needs to be addressed has been included in this report. This is largely true because of time and deadline requirements and also because this issue will be pursued throughout 2004.



Harry A. Green, Ph.D.  
Executive Director



# TABLE OF CONTENTS

<b>EXECUTIVE SUMMARY .....</b>	<b>v</b>
<b>INTRODUCTION .....</b>	<b>1</b>
<b>STATE TAX SHARING PROGRAMS IN THE U.S. AND SOUTHEAST .....</b>	<b>2</b>
Status of State Aid to Local Governments - State Policy Reports .....	6
<b>STATE TAX SHARING IN TENNESSEE .....</b>	<b>8</b>
<b>STATE TAX SHARING HISTORY .....</b>	<b>12</b>
Gasoline and Diesel Fuel Taxes .....	12
Hall Income Tax .....	13
State Sales Tax Distribution to Cities .....	14
Premier Type Tourist Resorts .....	15
TVA Distribution to Cities and Counties .....	16
Bank Excise Tax Distribution .....	18
Beer Excise Tax .....	19
Alcoholic Beverage Taxes .....	19
Mixed Drink Tax .....	19
17% Wholesale Beer Tax .....	20
<b>STATE TAX SHARING PRINCIPLES: THE ISSUE OF FAIRNESS .....</b>	<b>21</b>
The Issue of Fairness in State-Shared Taxes .....	22
Some Equity Issues to be Considered .....	22
Tax Sharing Principles and the Tax Modernization and Reform Commission .....	23
Lessons from the Federal General Revenue Sharing Program .....	27
Revenue Sharing Case Study: Revenue Sharing in Michigan .....	29
<b>RECENT STUDIES ON TAX SHARING IN TENNESSEE .....</b>	<b>32</b>
TACIR: State-Shared Taxes in Tennessee .....	32
MTSU: Sharing Taxes Between State and Local Governments in Tennessee .....	32
<b>TENNESSEE LOCAL UNITS OF GOVERNMENT .....</b>	<b>35</b>
Financing Local Government Activity .....	36
<b>CITY GOVERNMENT IN TENNESSEE AND THE SOUTHEAST .....</b>	<b>39</b>
City Government in Tennessee .....	41
City Services and State Policy .....	43
Tennessee Growth Planning Law .....	43
City Services .....	47

City Data Sources .....	50
Detailed Discussion of City Services.....	51
Police Services .....	51
Fire Services .....	53
Water Services.....	57
Sewer Services .....	58
Solid Waste Services .....	60
Streets .....	61
Parks and Recreation .....	62
Other City Services .....	64
State Role in City Services.....	65
City Services: Summary and Findings.....	67
Importance of State-Shared Taxes to City Government Operations .....	70
Streets and Highways .....	71
Evidence on the Importance of State-Shared Taxes for Other City Expenditures .....	72
Evidence on the Importance of State-Shared Taxes to Cities With and Without Property Taxes .....	72
<b>COUNTY GOVERNMENT IN TENNESSEE .....</b>	<b>73</b>
Education .....	75
Fire Protection .....	76
Police.....	76
Correction .....	77
Transportation-Highways.....	77
Governmental Administration-Judicial and Legal.....	78
Solid Waste Management.....	78
Parks and Recreation .....	78
Health .....	79
Importance of State-Shared Taxes to County Government Operations .....	79
<b>THE MOST APPARENT INEQUITIES .....</b>	<b>80</b>
Introduction .....	80
Cities Without Property Taxes .....	81
Gasoline and Motor Fuel Taxes (Counties) .....	81
Hall Income Tax.....	82
TVA Payments in Lieu of Taxes (Counties).....	83
Premier Type Resort Areas .....	83
City Versus County Distributions .....	85
Cities that Provide Limited Services.....	85
<b>APPENDIX.....</b>	<b>87</b>
<b>BIBLIOGRAPHY .....</b>	<b>143</b>

# EXECUTIVE SUMMARY

## INTRODUCTION

This study was initiated by a request from the Speaker of the House of Representatives to study fairness in the distribution of state-shared taxes. This simple request is actually very complex because it involves not only an examination of the concept of fairness and the application of equity concepts to the distribution formulas but also an analysis of the fiscal behavior and relationships among city and county governments. This involves an examination of the kinds and quality of services offered and how they are financed. How important are state-shared taxes? How many services are offered? Are they high quality or minimum quality, or something in between? What fiscal effort is made to provide for these services?

A major challenge to researchers of local governments in Tennessee is the absence of a generally accessible database that contains detailed city and county fiscal data. In this report, the TACIR staff has used a number of sources, but by far the most important one is the U.S. Census of Governments for 1997 (COG 97). Where possible, the COG 97 has been updated or tested by more current data. The COG 97 is a comprehensive source that covers all local governments in Tennessee. Most governments respond to the survey, but since it is voluntary, some do not. Also, the quality of the data is constrained by how local responders interpret the meaning of questions asked, how much time is devoted to answering them, and whether the responders reply to all questions or requests. A final limitation is that the data was collected in 1997.

This report examines the significance of state-shared taxes in Tennessee and their fiscal importance to city and county governments.

Cities and counties have relied on state-shared taxes to varying degrees for more than 100 years. Their importance to local governments varies from tax to tax and from place to place. Each tax has its own unique distribution formula—in some cases they favor counties, in some cases cities, and in some cases both are treated alike. Some taxes have restrictions on how they can

This study was undertaken to address the issue of fairness in the distribution of state-shared taxes in Tennessee.

be used. In addition, the amounts generated by some taxes are more volatile than others, fluctuating widely from year to year. The more volatile taxes make less reliable sources of revenue for recurring obligations. Consequently, the impact on local governments of such volatility varies, depending on the relative importance of the different shared taxes to the local revenue stream.

### ***TAXES SUBJECT TO SHARING***

As shown in Table A, Tennessee shares portions of 12 taxes with its local governments. State gasoline and motor fuel taxes made up nearly 36% of all state-shared taxes in fiscal year 2003. Both

**Table A. Distributions of State-Shared Taxes and Percent of State Total  
Fiscal Year 2003**

State-Shared Revenues By Source	Total Amount Distributed (thousands)	Percent
Alcoholic Beverage Tax	\$ 5,450	0.72%
Beer Excise Tax	3,333	0.44%
Corporate Excise Tax <sup>1</sup>	17,263	2.29%
Gasoline Tax & Motor Fuel Tax <sup>2</sup>	268,782	35.64%
Gross Receipts Tax-TVA Replace. Rev.	74,130	9.83%
Special Petroleum Tax	11,897	1.58%
Hall Income Tax	50,516	6.70%
Mixed Drink Tax	18,293	2.43%
Sales and Use Tax	202,176	26.81%
Crude Oil & Natural Gas Severance Tax & Coal Severance Tax	745	0.10%
<b>Subtotal</b>	<b>\$ 652,585</b>	<b>86.54%</b>
Beer Wholesale Tax <sup>3</sup>	101,500	13.46%
<b>Total</b>	<b>\$ 754,085</b>	<b>100.00%</b>
Note: Distributions to County Technical Assistance Service, Municipal Technical Advisory Service, UT Center for Government Training, and the TACIR equal \$4.5 million. <sup>4</sup>		
Sources: Tennessee Department of Revenue and Tennessee Malt Beverage Association		

<sup>1</sup> Local governments commonly refer to their distributions from this tax as Bank Excise Tax distributions.

<sup>2</sup> The Tennessee Department of Revenue reports the Gasoline Tax and Motor Fuel Tax distributions as one category.

<sup>3</sup> Data on the distribution of the 17% wholesale beer tax has traditionally not been included in the data released by the Department of Revenue. While the tax is a state levy, it has been treated in statistical releases as a local tax since local governments receive most of the revenue (96.5%).

<sup>4</sup> These distributions to non-local government entities are reported by the Tennessee Department of Revenue under the category of municipal distributions.

cities and counties receive these funds each year. Allocations from the state sales and use taxes, which are distributed only to cities, made up another 27% of the total. Ten other taxes made up the remaining 37%.

### ***SIGNIFICANCE TO THE STATE***

The significance to the state of state-shared taxes is readily apparent when one examines the amounts of recent distributions and projected future distributions, as well as state-shared allocations as a percent of total fund allocations.

During fiscal year 2003, the State of Tennessee shared over \$653 million dollars with its local governments.<sup>5</sup> An additional \$4.5 million was distributed to various state agencies, including the Municipal Technical Advisory Service, the University of Tennessee Center for Government Training, the County Technical Assistance Service, and the Tennessee Advisory Commission on Intergovernmental Relations. The total amount includes the beer wholesale tax distributions, a state-shared tax often excluded in reports because 96.5 percent of its collections are returned to local governments. Although this tax is collected and remitted by the beer wholesalers, it is a state tax, with the Department of Revenue responsible for its administration. Wholesalers retain three percent of the gross tax to defray their costs associated with collecting and remitting the tax; the Department of Revenue retains one half of one percent to cover administration expenses.

### ***WHY DOES STATE GOVERNMENT SHARE TAXES?***

The answer to this question is anything but straightforward. In the text of the report several possible reasons have been identified. No attempt has been made to quantify the significance or rank the importance of each. In fact, this is largely an intellectual exercise because no policy explanations for state-shared taxes are found in the statutes. The most significant reasons may be:

- recognition that the provision of public service requires a state-local partnership

<sup>5</sup> If the wholesale beer tax is included, the total is \$754 million.

During  
FY 2003,  
\$754 million  
including the  
17% wholesale  
beer tax was  
distributed to  
local  
governments:  
\$465 million to  
city  
governments  
and \$289 to  
county  
governments.

The State sales tax, which is shared with city governments, historically has a high rate of growth over a business cycle.

The gasoline tax, which ranks second only to the sales tax in dollar size, exhibits little growth over time.

- compensation for limitations placed on local tax bases (or inadequate tax bases)
- to compensate for State mandates
- to promote low property tax burdens
- to promote and maintain a state-local highway system

### **GROWTH, VOLATILITY, AND TRENDS OF STATE-SHARED TAXES**

Existing state-shared taxes differ considerably in their ability over the long run to generate revenue growth sufficient to fund growing levels of needed state and local expenditures. In addition, shared taxes vary significantly in their response to changes in economic conditions, especially during recessions. The evidence from data covering the period 1988 through 1998 shows the following:

1. Of the taxes shared with local governments, franchise and excise taxes, sales and use taxes, motor vehicle fuel taxes, and Hall income taxes exhibit the highest estimated average annual rates of growth (6.4%, 5.9%, 4.9%, and 4.7% respectively).
2. The gasoline tax, which represents the single largest shared tax source, exhibits little growth over time.
3. The Hall income tax, while representing an important source of growing shared revenue to city and county governments, is the most volatile shared tax source.

The measure of volatility for each tax can be compared to the estimated volatility of Tennessee personal income. All taxes, except for the beer tax, exhibit more volatility over the period than Tennessee personal income. So, the ups and downs of economic activity affect all taxes, just as it affects personal income. Some taxes exhibit more volatility during economic fluctuations than personal income (which, as expected, fluctuates over the business cycle). The estimated growth and volatility measures in the table can be interpreted in relation to the values calculated for Tennessee personal income.

State-shared taxes and other aid to local governments in Tennessee have exhibited three long-run trends:



**Table B. Growth and Volatility of Tennessee State-Shared Taxes, 1988-1998**  
**Ranked High to Low by Annual Rate of Growth**

Tax	Annual Rate of Growth	Volatility	Rank
Franchise & Excise (Combined)	6.4%	7.3%	1
Sales and Use	5.9%	3.1%	2
Motor Vehicle Fuel	4.9%	4.5%	3
Hall Income	4.7%	10.3%	4
Mixed Drink	2.5%	2.8%	5
TVA Payments	1.8%	2.5%	6
Beer Tax	1.6%	1.0%	7
Gasoline Tax	1.4%	2.0%	8
Special Petroleum	1.4%	3.6%	9
Alcoholic Beverage	-0.1%	2.1%	10
Total for 10 taxes	5.2%	2.1%	
Baseline: Tenn. Personal Income	6.3%	1.1%	

Note: Average annual growth is calculated by regressing the natural log of a tax on a linear trend (a constant was included). The estimated coefficient is reported as a percent. The volatility (measured as trend deviation) reported is the standard deviation of calculated residuals. Due to data limitations, franchise and excise taxes are combined and treated as one tax in this analysis.

Source: TACIR

- the distribution of state taxes to county and city governments has declined as a percent of total state taxes between 1970 and 2003;
- however, categorical grants, the other major type of intergovernmental aid to local governments, have been increasing; and
- the gap between county and city distributions has widened over the thirty-three (33) year period. In 1970, both were allocated just over \$41 million in total distributions. By 2003, city distributions had grown to nearly \$384 million, while county distributions lagged behind at \$269 million. However, this does not include BEP funding which mainly benefits county school systems.

The gap between city and county distributions has widened during the period, 1970-1993.

**Table C. Allocation of Tennessee Tax Collections, Selected Years (*in thousands*)**

	1970	1998	2003
ALLOCATED TO COUNTIES	\$41,286	\$250,632	\$268,906
Share of Total Funds Allocated	6.27%	3.71%	3.59%
ALLOCATED TO MUNICIPALITIES	\$41,730	\$346,451	\$383,679
Share of Total Funds Allocated	6.34%	5.13%	5.13%
TOTAL ALLOCATED TO LOCAL GOVERNMENTS	\$83,016	\$597,083	\$652,585
Sum of Shares of County & City Funds	12.61%	8.84%	8.72%
TOTAL ALLOCATED TO ALL FUNDS	\$658,214	\$6,751,543	\$7,482,302

Sources: Tennessee Department of Revenue *Biennial Reports* and Department of Finance and Administration.

Note: Data excludes wholesale beer tax distributions.

### ***DISTRIBUTION METHODS***

Tennessee uses four methods for distributing shared tax revenues:

- situs-based distributions, which are distributions to the jurisdictions in which the taxes are collected,
- distributions based on population, also referred to as per capita-based distributions,
- distributions based on land area, and
- distributions based on equal shares [for example, each of the 95 counties would receive 1/95 of the revenue].

Table D shows which distribution method is used for each state-shared tax and whether the tax is distributed to cities, to counties or to both.

**Table D. Distribution Recipients and Basis of State-Shared Taxes with Local Governments, FY 1999**

<b>Tax</b>	<b>Distribution Recipient</b>	<b>Distribution Basis</b>
Alcoholic Beverage	Counties, Selected Cities	<b>Population and Land Area.</b> County share is based $\frac{1}{4}$ on area and $\frac{3}{4}$ on population; 30% of the amount distributed to counties of more than 250,000 population having a contained city of 150,000 shall be paid to the city.
Beer Excise (\$3.90 per barrel)	Counties, Cities	<b>Population and Equal Shares.</b> Cities share on a population basis and counties share equally.
17% Wholesale Beer Tax	Counties, Cities	<b>Situs</b> of retailer making wholesale purchase.
Corporate Excise (Corporate Income tax)	Counties, Cities	<b>Situs</b> of bank deposits and level of property taxes.
Gasoline	Counties, Cities	<b>Population, Land Area, and Equal Shares.</b> County share based $\frac{1}{4}$ on population, $\frac{1}{4}$ on county area, $\frac{1}{2}$ is shared equally. Cities' shares based on population.
Income, Hall	Counties, Cities	<b>Situs.</b> Based on situs of taxpayer.
Mixed Drink	Counties, Cities	<b>Situs</b> of collection.
Motor Fuel	Counties, Cities	<b>Population, Land Area, and Equal Shares.</b> County amounts based $\frac{1}{4}$ on population, $\frac{1}{4}$ on county area, and $\frac{1}{2}$ is shared equally. City shares based only on population.
Sales & Use	Cities	<b>Population</b> of cities.
Severance –Coal	Counties	<b>Situs</b> of severance.
Severance – Crude Oil & Natural Gas	Counties	<b>Situs</b> of wellhead severance.
Special Petroleum Products	Counties, Cities	<b>Population.</b>
TVA Payments	Cities, Counties	<b>Population, Land Area, and TVA Owned Land.</b> County share based 43% on population, 43% on area, and 14% on TVA owned land; city share based on population.

Sources: Tennessee Code Annotated, Tennessee Department of Revenue.

Gasoline and related motor fuel taxes are restricted in their use. Other funds are largely unrestricted.

### ***RESTRICTIONS ON USE BY LOCAL GOVERNMENTS***

State-shared taxes can be restricted or unrestricted. Table E shows which state-shared taxes are restricted and which are not. Shared highway taxes, including the gasoline and motor fuel taxes and the special petroleum tax, represent a majority of restricted revenue. These funds can be used only for roads, and to a very limited extent, mass transit. Half of the revenues from the mixed drink tax must be spent on education. Cities and counties that receive restricted revenues have come to rely on them for those purposes and have responded to such aid by using their own-source revenue in other areas.

**Table E. Restricted and Unrestricted State-Shared Taxes in Tennessee**

<b>State-Shared Tax</b>	<b>Restricted</b>	<b>Restriction</b>
Alcoholic Beverage Tax	No	–
Beer Excise Tax	No	–
Beer Wholesale Tax	No	–
Corporate Excise Tax	No	–
Gasoline Tax	Yes	Roads & Mass Transit
Motor Fuel Tax	Yes	Roads & Mass Transit
TVA Payments	No	–
Special Petroleum Tax	Yes	Roads
Hall Income Tax	No	–
Mixed Drink Tax	50% is earmarked	Education
Sales and Use Tax	No	–
Coal Severance Tax	Yes	Education & Highway/ Stream Cleaning
Crude Oil and Natural Gas Severance Tax	No	–

Sources: Tennessee Code Annotated, TN Department of Revenue.

Table F. Selected Characteristics of State-Shared Taxes

Tax	Recipient	FY 2003 Amount	Restrictions on Use	Volatility	1988-1998 Growth Rate	TCA Citations
Sales and Use Tax	Cities	\$ 202,176,200	None	3.1%	5.9%	67-6-103
	Counties	n/a	n/a			
Gasoline Tax and Motor Vehicle Fuel Tax <sup>6</sup>	Cities	89,717,013	Roads & Mass Transit	4.5% (Motor Fuel), 2.0% (Gasoline)	4.9% (Motor Fuel), 1.4% (Gasoline)	54-4-103, 54-4-203, 67-3-2001/2005/2008
	Counties	179,064,463				
Special Petroleum Tax	Cities	7,318,000	Roads	3.6%	1.4%	67-3-2006
	Counties	4,579,000				
Hall Income Tax	Cities	42,332,061	None	10.3%	4.7%	67-2-119
	Counties	8,183,423				
TVA Payments	Cities	21,372,517	None	2.5%	1.8%	67-9-101/102/103
	Counties	52,757,280				
Beer Excise Tax	Cities	1,666,288	None	1.0%	1.6%	57-5-205
	Counties	1,666,288				
Beer Wholesale Tax	Cities	81,575,898	None	Not Measured		57-6-103
	Counties	19,924,102				
Alcoholic Beverage Tax	Cities	Approximately 1,000	None	2.1%	-0.1%	57-3-306
	Counties	5,450,423				
Corporate Excise Tax	Cities	6,422,667	None	Not Measured		67-4-2017
	Counties	10,839,895				
Mixed Drink Tax	Cities	12,237,257	1/2 to Education	2.8%	2.5%	57-4-306
	Counties	6,055,457				
Crude Oil and Natural Gas Severance Tax	Cities	n/a	None	Not Measured		60-1-301
	Counties	166,000				
Coal Severance Tax	Cities	n/a	1/2 Education, 1/2 Hwy/Stream Cleaning	Not Measured		67-7-110
	Counties	579,000				
<b>Total<sup>7</sup></b>		<b>\$ 754,084,232</b>				

Of these 12 taxes, the Hall Income tax is the most volatile and the beer tax the least.

<sup>6</sup> The Department of Revenue reports distributions for these two taxes as one category.

<sup>7</sup> Does not include \$2.47 million in "municipal" distributions to non-municipalities.

## CITY SERVICES

A city is a special type of corporation established and operating under state law. There are 348 cities in Tennessee and each is characterized as either a city or a town (in our state, there is no legal distinction between the two). These cities and towns range in size from Memphis (666,786), to Silerton (60), but three-fifths of them (209 cities) are below 2,500 population. About 59% of the state's residents live in a city.

**Table G. Distribution of Tennessee Cities by Population Size**

Population Size	Number	Percent of All Municipalities	Population	% of Municipal Population
Over 100,000	5	2%	1,645,209	49%
50,000-99,999	3	1%	184,013	5%
25,000-49,999	12	4%	420,397	12%
10,000-24,999	28	8%	434,942	13%
5,000-9,999	39	11%	273,783	8%
2,500-4,999	49	14%	187,595	6%
1,000-2,499	95	27%	152,850	5%
Under 1,000	117	33%	58,463	2%
<b>Total</b>	<b>348</b>	<b>100%</b>	<b>3,357,252</b>	<b>100%</b>

Source: Municipal Technical Advisory Service (MTAS), University of Tennessee, *Directory of Tennessee Municipal Officials*, September 2002.

46% or 162 of existing cities could not qualify today because they fail to meet the minimum standard of 1,500 people.

Since passage of recent legislation, new restrictions and requirements make incorporation much more difficult. Forty-six percent (162) of the existing cities could not qualify for incorporation today because of the 1,500 minimum population threshold.

The highest rationale for becoming a city is to provide more services and a higher level of services. Cities should be about services because, prior to incorporation, citizens are already receiving “default” services from the county or a utility district. “Default” services are those that are available without having a city. The seven essential services are police, fire, water, sewer, street construction and maintenance, solid waste, and parks and recreation. These functions are cited in the statutory plan of services required for new incorporations.<sup>8</sup>

<sup>8</sup> TCA 6-1-201; TCA 6-18-103; TCA 6-30-104; TCA 6-58-101 et seq.



In evaluating services provided to citizens, one must look to the level of service and what entity is providing it. "Full service" cities are those that provide the service, own or control the service, and/or have financial responsibility for the service. By that definition, the full service level among the 348 Tennessee cities is as follows: Police-56%; Fire-19%; Water-59%; Sewer-59%; Solid Waste-67%; and Parks and Recreation-30%. About 1/3 of all cities provide no solid waste service, and citizens have to make their own arrangements for private service or take their trash to a county pickup center.

### **COUNTY SERVICES**

County governments, in contrast to cities, are required by a combination of constitutional and statutory mandates to provide certain services to their citizens. This results in a fairly consistent pattern of services being provided in all counties. County services provided in most counties include:

1. primary and secondary education system
2. law enforcement, generally through a Sheriff's Department
3. jails and/or workhouses
4. court system
5. county highways, bridges, and streets
6. solid waste program
7. operation of Constitutional County Offices
8. emergency management operations
9. county medical examiner office
10. election commission and its operations
11. health department
12. county fire or volunteer fire fighting operation

**Table H. Summary of City Services Provided**

<b># of Services Provided</b>	<b># of Cities Providing Services (Based on COG97)</b>
1	17
2	23
3	37
4	28
5	44
6	73
7	122
<b>Total</b>	<b>344</b>

Note: Services include: police, fire, streets and highways, parks and recreation, solid waste, water, and sewer.

Source: 1997 Census of Governments.

Of the 344 cities reporting, only 122 or 35% provide the 7 services required of new incorporations.

County governments are more dependent on shared taxes for highways and roads than is true for cities.

The level of service and the amount spent in each county varies on a per capita basis for several reasons, the most important of which are: (1) in some counties, the presence of cities that provide city residents with services such as a city school system, police and/or fire protection, solid waste services and street and road services, reduce service demands on the respective county government; (2) as was true for many cities, some counties and their residents are willing and able to spend more on certain services and some counties are willing to spend much less on certain services.

County expenditure patterns and county-state fiscal dependence measures were developed using the primary data source used to produce measures of city fiscal activity. In general, the 1997 Census of Governments data for counties was more complete and consistent than was true for cities. The data consists of detailed information on revenue and expenditures for 93 counties. Metropolitan governments such as Nashville-Davidson County and Lynchburg-Moore County are treated as cities by the U. S. Census in its Census of Governments surveys.

The report provides some detailed information on the spending patterns of county governments. The data shows that all counties provided services consistent with their nature as the default level of government to most Tennessee citizens. For those Tennesseans living outside of cities, as well as for many citizens living in relatively small cities, the bulk of public services to such residents was delivered by county governments.

The importance of state-shared taxes to county government operations varies by type of program. In general, county expenditures on highways and roads are more dependent on state-shared taxes than is true for cities, but less dependent on state-shared taxes for other categories of spending. The higher dependence on state highway taxes may reflect a lower willingness of counties to spend their own tax funds on local roads, or the relatively larger state distribution of highway funds to counties than to cities. During fiscal year 2003, counties received twice as much shared gasoline and motor fuel tax revenue as cities (\$179.1 million versus \$89.7 for cities).

The importance of state general support aid (unrestricted revenue) to county governments is less than for cities. For all but six of the

93 counties included in the 1997 survey data, unrestricted state-shared tax revenues represented less than 5% of total county revenues. For the six counties that had a calculated dependence of over 5%, none exceeded ten percent dependence.<sup>9</sup>

### ***EQUITY AND FAIRNESS IN STATE-SHARED TAXES***

It has been said that “equity” like “beauty” is in the eyes of the beholder. While equity has received considerable attention relative to K-12 education over the past 15 years, it is not a term that is usually identified with state-shared taxes.

The work of the Tennessee Tax Modernization and Reform Commission (TTMRC) of 1972-1974 paid considerable attention to equity and fairness. In fact, the Commission found that most state-shared tax formulas were inequitable. The Commission held that most existing formulas be converted to a population basis in order to treat all citizens fairly. However, the Commission also considered a “needs-based” formula for the distribution of gasoline and motor fuel shared taxes that would include factors such as road miles and registered vehicles. Unable to resolve differences on this proposal, the Commission recommended a phase-out of the existing formula and a gradual move to population-base sharing.

The recommendations of TTMRC were duly noted and filed away. In the past 30 years, there has been no serious discussion of equity and fairness as the concepts relate to state-shared taxes.

As requested of the Commission, TACIR staff has examined equity and fairness in state-shared taxes. The staff reviewed the following:

- TTMRC reports
- the Federal general revenue-sharing formula
- recent reform in Michigan
- concepts of equity in the literature on public finance and taxation

In general, the Tennessee Tax Modernization and Reform Commission (1974) found the formulas of all state-shared taxes to be inequitable and recommended greater use of population and “needs base” factors for distribution. Additionally, local fiscal effort was considered a major factor in the assessment of fairness.

<sup>9</sup>The six counties were Stewart, Benton, Lake, Hickman, Carroll, and Perry.

This report identifies 7 examples of the most apparent inequities in the distribution of state-shared taxes.

The TACIR staff found the following as the most apparent examples of inequity:

- The fact that 84 cities do not levy a property tax, are low-services cities and are able to maintain that condition because of state-shared taxes.
- The fact that one-half of county shared gasoline and motor fuel taxes are based on equal shares. This means that the smallest county (whether based on area or population) receives exactly the same amount as the largest county.
- The fact that three eighths (or 38%) of the Hall income tax is shared on the basis of situs, or where it is collected. No equity principle that justifies this formula was discovered.
- The fact that 57% of TVA payments in lieu of taxes distributed to counties is based on area: 43% based on county acreage and 14% based on TVA area. No meaningful relationship between needs and the TVA payment distributions was found. The correlation coefficient between population and area is only 0.32. A perfect relationship would be 1.0.
- The fact that extraordinary sales tax payments are made to “Premier Type Resort Areas.” By statutory definition, there are only two cities that receive these payments: Gatlinburg and Pigeon Forge. With these extraordinary payments and high local sales tax collections, these cities (and Sevier County government) can maintain very low comparative property tax rates, a near average local sales tax rate, and relatively low hotel/motel tax rates.
- Another issue relates to the amount of shared taxes distributed to all city governments compared to the distribution to all county governments. No equity principles were discovered that relate directly to this issue. The question that would seem to be relevant is: are the needs of city governments (and city residents) greater than the needs of county governments (and non-city residents). In 1970, the amounts distributed were approximately equal. By 2002, city governments were receiving \$108 million

more than county governments (not counting the wholesale beer tax).

- Population, or per capita distributions, have long been advocated and used as measures of equity. However, population doesn't always relate to needs. For example, the correlation between population and county area is very low. Likewise, the correlation between population and miles of roads is very low. And, there is no statistical relationship between population and equal shares.
- A major purpose of cities is to provide services, but there are cities that provide limited services. In 1997 there were 77 cities (or towns) that offered 3 or fewer services to their citizens. Based on PC 1101, these cities would be required to develop a plan of services for the provision of 7 services.

## ***FINDINGS***

### **General**

- While Tennessee (27.4%) ranks below the South Region average (29.9%) in state intergovernmental aid (as percent of State general revenue), Tennessee (16.6%) ranks above the region (8.1%) in shared taxes as a percent of intergovernmental aid.
- The level of unrestricted state financial aid (including state-shared taxes) is higher in Tennessee than in other Southeastern states.
- State intergovernmental aid is a smaller share of state general revenue (27.4%) than the U.S. average (33.2%).
- In terms of equity (or fairness) in the state tax sharing distribution formulas, those that use population for distribution are the most equitable. No equity principles were discovered that justify using situs or equal shares for distribution.

### **City Governments**

- The current statutory minimum for city incorporation is 1,500 people, or 5,000 if an incorporation is sought under the modified city-manager charter. Presently, 162 cities,

or 46% of the total number, are smaller than 1,500 and would not qualify for incorporation today.

- During FY 2002, 84 cities did not have a property tax. At best, these cities make a minimal fiscal effort and offer few services. Current law (PC 1101) requires new cities to enact a property tax that produces tax revenue equal to state-shared taxes.
- Cities that do not impose a property tax are mostly small, less than 2,500 people. These cities are more dependent on state-shared taxes than the 264 that do impose a property tax.
- Based on Census of Government data (COG 97), only 122 cities of the 344 reporting provide some level of service for all seven service areas required to be included in a newly incorporated city's plan of services. Seventy-seven (77) cities provide only three or fewer services.
- Based on COG 97 data, only 61 cities (of 300 reporting) can be categorized as a "full service" city. (Note: based on the requirement that per capita spending should be at least 50% of the median amount spent).
- Tennessee is a state of small cities. In 2002, there were 348 cities in Tennessee ranging in size from 60 people (Silerton) to 668,000 (Memphis).
- Small cities, and particularly cities with populations under 1,000 persons (162), rely heavily on state-shared revenues for much of what they spend. Of the 28 cities with a ratio above 1:0 (state shared revenue to city expenditures), 19 had populations less than 1,000.
- Fifty-four percent (54%) of the total city population resides in only 8 cities. In contrast, only 2% of Tennessee's city population lives in 117 cities.



- Total spending for all cities (COG 97):

<b>CITY GOVERNMENTS (in thousands)</b>	
General Purpose	\$ 2,434,988
Education	473,378
<b>Subtotal</b>	<b>\$ 2,908,366</b>
Utilities	3,736,364
<b>Grand Total</b>	<b>\$ 6,644,730</b>

Note: Education expenditures for Lynchburg/Moore County and Nashville/Davidson County are not included in these calculations. Also, education expenditures for Memphis are not included in these calculations, as Memphis has a special school district, not a city school system.

Excluding utility expenditures, total city government expenditures in Tennessee for FY 1997 was almost \$3.0 billion.

### **County Governments**

- There are 95 counties in Tennessee. The smallest is Pickett County and has a population of 4,633. The largest is Shelby County and has a population of 867,409. (COG 97). Under the gasoline tax formula, 50% of the funds are divided into equal shares among the 95 counties. This means that Pickett County receives the same share as Shelby County.
- The COG 97 data indicated that 91 county governments and two metropolitan governments operate education systems. Carroll and Gibson counties provide education services but do not operate complete systems. These 2 counties rely on special school districts. Total county education spending was \$3.0 billion (including Davidson and Moore).
- Eighty-two (82) counties reported spending \$24.5 million on fire services. In some counties, fire services are provided by specific fire districts. Per capita spending varied from a low of \$.04 to a high of \$24.87.
- Ninety-three (93) counties reported spending a total of \$154 million on “police services” that included sheriff departments or other law enforcement activities (not including jails). Eighty-eight (88) counties reported spending \$152 million in the corrections category.

Excluding utility expenditures, total county government expenditures in Tennessee for FY 1997 was \$5.5 billion.

- Ninety-one (91) counties reported spending \$212 million on county roads and highways. Per capita spending ranged from a low of \$12.90 in Shelby County to a high of \$246.78 in Van Buren County.
- Other categories of spending are:  
 Court Related Activities (93 counties) - \$125 million  
 Solid Waste Management (92 counties) - \$69 million  
 Parks and Recreation (76 counties) - \$25 million  
 Health (93 counties) - \$131 million
- For citizens living in unincorporated areas, and some living in small cities, the bulk of public services delivered is by county governments.
- Total spending for all service categories (COG 97):

<b>COUNTY GOVERNMENTS (in thousands)</b>	
General Purpose	\$ 2,502,830
Education	<u>3,008,836</u>
<b>Subtotal</b>	\$ 5,511,666
Utilities	<u>60,917</u>
<b>Grand Total</b>	\$ 5,572,583

Note: These calculations include education expenditures for Lynchburg/Moore County and Nashville/Davidson County because these school systems are treated as county school systems by the Tennessee Department of Education.

# INTRODUCTION

In 1972, Kenneth Quindry and Richard Engels, staff to the Tennessee Tax Modernization and Reform Commission, analyzed state-local shared taxes and noted the following:

“State systems for sharing state-collected taxes are not usually recognized for logic or soundness. It is evident from the language of the various state statutes that there has evolved a mere patchwork developed from an earlier era more for political expediency than for fiscal relief and impact.”<sup>1</sup>

The authors went on to evaluate and recommend changes to the then existing statutory methods used to distribute state motor fuel taxes, other shared taxes for general government aid to counties and cities, and state categorical aid to local school systems. While much has changed in the 30 plus years since these researchers studied state tax sharing in Tennessee, much has not. Most formulas remain unchanged while local needs and demographics have changed considerably.

The State of Tennessee distributed \$653 million of its tax revenue to city and county governments during fiscal year 2003.<sup>2</sup> Approximately 59% was distributed to city governments, and 41% to county governments. Of the total amount distributed, \$269 million represents shared state highway fuel tax revenue which is restricted for use only on local streets and highways. With a few minor exceptions,<sup>3</sup> the balance of \$384 million may be used for whatever purpose local governments choose.

The subject of state tax sharing with local governments has been studied several times in the recent past. TACIR analyzed the subject most recently in 2000. While the content of these reports will be summarized in the material that follows, the present report will emphasize and focus on elements of state tax sharing that

---

<sup>1</sup>Quindry and Engels (1972), p. 4.

<sup>2</sup>Preliminary data released by the Tennessee Department of Revenue. See tables in Appendix for detailed distribution statistics. This figure does not include the distribution of \$101.5 million to local governments from the 17% Wholesale Beer Tax. For a discussion of this subject, see the history section of the report.

<sup>3</sup>Half of mixed drink tax distributions are earmarked for education. Special rules apply in some cities that do not run their own school systems. See T.C.A. 57-4-306.

have either not recently been addressed or not addressed in sufficient detail. This is especially true in light of the state's continuing fiscal plight and the inclusion of state-shared taxes in recent state budget cutting measures.<sup>4</sup>

The report will summarize and/or analyze the following subjects:

- a brief review of state tax sharing in the United States;
- a review of current tax sharing arrangements in Tennessee;
- a discussion of tax sharing principles and options with special case studies;
- a review of recent Tennessee reports on tax sharing;
- an analysis of city governments in Tennessee: history, development, and comparisons with other states;
- a statistical description of the variety of city governments in Tennessee: full service cities, part service cities, no service cities;
- an analysis of the importance of state-shared taxes to cities; and
- an analysis of state-shared taxes with counties.

## **STATE TAX SHARING PROGRAMS IN THE U.S. AND THE SOUTHEAST**

State tax sharing is one of two forms of state intergovernmental aid to local governments. The other form consists of appropriated categorical grants-in-aid. Minor forms of intergovernmental aid include the redistribution of some federal payments in lieu of taxes and some reimbursement programs (such as for local revenue lost through state property tax circuit-breaker programs or state-mandated homestead exemptions; as well as for various services

---

<sup>4</sup>See a description of the recent cuts to state tax sharing in Chervin and Green, *Hall Income Tax Distributions and Local Government Finances*, August, 2003, page 4. Material was presented at the August 28<sup>th</sup> 2003 meeting of the Tennessee Advisory Commission on Intergovernmental Relations.

provided by local governments to the state, such as for prisoner housing).

**Table 1. State Intergovernmental Expenditures, FY 2000 Data**

State And Region	Amount (In Millions)	Percent of State General Revenue	Percent that is Restricted	Percent General Support	Percent From Shared Taxes
US	\$327,069.8	33.2%	91.6%	8.4%	NA
South Region	\$64,100.1	29.9%	91.3%	8.7%	8.1%
Alabama	\$3,908.4	27.7%	97.2%	2.8%	8.3%
Arkansas	\$2,725.2	29.9%	98.3%	1.7%	7.3%
Florida	\$14,073.4	33.8%	81.2%	18.8%	4.7%
Georgia	\$7,179.7	30.7%	98.9%	1.1%	0.0%
Kentucky	\$3,280.1	22.4%	100.0%	0.0%	5.2%
Louisiana	\$3,721.6	25.0%	95.1%	4.9%	4.0%
Mississippi	\$3,248.0	33.7%	80.9%	19.1%	17.3%
North Carolina	\$9,301.1	33.5%	92.5%	7.5%	18.2%
South Carolina	\$3,806.1	28.6%	80.0%	20.0%	18.5%
Tennessee	\$4,364.4	27.4%	91.4%	8.6%	16.8%
Virginia	\$7,132.4	31.4%	99.4%	0.6%	0.0%
West Virginia	\$1,359.7	19.3%	99.0%	1.0%	1.1%

Source: U. S. Census, Census of Government Website

Notes:

General revenue comprises all revenue except that classified as liquor store, utility, or insurance trust revenue.

General Support calculated from detailed Census state data as sum of M30+N30+R30.

State-shared tax data from individual states.

States use four primary methods for distributing intergovernmental aid. They are as follows:

1. **Situs or origin-based distributions.** Distributions based on situs or origin refer primarily to distributions of state taxes that are directly shared with local governments based on the situs of the tax collection or the situs of the taxpayer.
2. **Reimbursement programs.** Distributions to local governments based on state programs designed to provide state financed local tax relief to certain groups of citizens. The state will usually distribute funds to local governments to offset the revenue losses they experience as the result of a state-mandated tax relief program or a state-wide exemption that impacts local tax revenue.

States will also, in some situations, reimburse local governments for what would otherwise be unfunded mandates imposed on them by new legislation.

3. **Population or per capita-based distributions.** Next to situs-based distributions, this is the simplest method for distributing intergovernmental aid. To a certain degree, per capita-based distributions result in some revenue equalization among the recipients.
4. **Equalization and needs-based distributions.** This generic type of distribution is responsible for the largest portion of state intergovernmental aid and is found in hundreds of variations among the states. Sometimes the aid is conditional and requires a local contribution, sometimes not. There are as many individually unique distribution formulas or methods as there are state governments. The methods used often share certain common characteristics.

The largest categorical aid program in Tennessee is the Basic Education Program (BEP). It provides a substantial amount of state aid to local governments (including special school districts) for K-12 education. The best known and largest direct tax sharing program in Tennessee is the ongoing distribution of a portion of state gasoline and diesel fuel tax collections (shared with both city and county governments).

Comparable data for all states is available from the U. S. Census Department.<sup>5</sup> Table 1 presents data for intergovernmental aid for each state in the south, all southern states combined, and all states combined.<sup>6</sup> Given the fact that local education is generally the dominant program in the intergovernmental expenditure programs of most states, the similarities in the relative amount of intergovernmental aid that is restricted is not surprising.

It is surprising that some states provide little or no aid to local governments for general purpose use. Alabama, Arkansas, Georgia, Kentucky, Virginia, and West Virginia fit into this

---

<sup>5</sup>Fiscal year 2000 data is from the U. S. Bureau of the Census, Internet site <http://www.census.gov/govs/www/estimate>. The U. S. Census did not produce similar detailed data for FY 2001.

<sup>6</sup>Detailed data on state-shared taxes was not available for all states.

category. In contrast, intergovernmental aid provided by Florida,<sup>7</sup> Mississippi,<sup>8</sup> and South Carolina,<sup>9</sup> while still predominantly restricted, contains much higher levels of unrestricted aid (general support revenue).

The data for fiscal year 2000 shows that intergovernmental aid by Tennessee state government to its local governments (combined city and county) is a smaller share of state general revenue (27.4%) than both the U.S. average (33.2%) and the average for the southern states included in the table (29.9%). However the percent of aid that is made available for general support is almost equal to the southern state average, 8.6% for Tennessee versus 8.7% for all southern states, and slightly higher than that for the U.S. as a whole (8.4%).

In general, state intergovernmental aid to local government is the largest component of state expenditures. Based on the most current data from the U.S. Census Bureau, state governments provided local governments with \$327 billion in FY 2000. This figure includes direct payments to local governments through grants-in-aid (transfer of funds on a formula basis, such as for education), shared taxes (distribution of a portion or all of the revenue from a specific state tax or taxes), and reimbursement for the cost of certain programs carried out by localities.

From 1985 to 2000, payments to local governments have remained at an almost constant percentage of total general expenditures (32% to 35%). However, as reported in *The Fiscal Survey of States: June 2003* by the National Budget Officers' Association, states are struggling to balance their budgets and several have had to cut high priority programs including aid to towns and cities. In FY 2003, 10 states reduced aid to local governments.<sup>10</sup> These programs may be in even greater jeopardy

---

<sup>7</sup>Florida unrestricted aid to local governments comes from a blend of revenue sources: sales taxes, cigarette taxes, beverage licenses, insurance licenses, mobile home licenses, and oil and gas tax sources.

<sup>8</sup>Unrestricted aid to local government in Mississippi comes from the state sales tax.

<sup>9</sup>South Carolina is unique in providing local governments unrestricted aid equal to 4.5% of its previous years' state budget (apportioned based on population).

<sup>10</sup>National Governors Association (2003), page 29. The states listed were Connecticut, Massachusetts, Indiana, Michigan, Ohio, Kansas, Virginia, Arizona, California, and Oregon.



in the future (as proved true for local governments in Tennessee for FY 2004) if economic conditions remain stagnant or worsen and budget shortfalls grow.<sup>11</sup>

### ***STATUS OF STATE AID TO LOCAL GOVERNMENTS-STATE POLICY REPORTS<sup>12</sup>***

Comparisons among states on state aid to local governments are often difficult to interpret. The amount of money states give to local governments varies widely among states due to variation in the mix of state and local responsibilities, local-revenue-raising powers, and geographic differences. States assuming greater responsibility for services eliminate the need to fund programs through local governments. Also, states that provide local governments with a greater ability to raise revenue tend to have a smaller percentage of their expenditures going to local governments. Smaller states tend to be more fiscally centralized and fund more programs that local governments handle in larger states; larger states tend to be more fiscally decentralized and fund local governments to provide services.

In recent years local government finances have suffered from lower shared-revenues (since state taxes declined) and/or state shifting of responsibilities to local governments. Data show that state intergovernmental aid to local governments is the largest element of state expenditures (note that state aid includes K-12 funding). In FY 1999, state aid represented approximately 34% of total state general expenditures. State aid to locals as a percent of total expenditures varied from a low of 3% in Hawaii (State of Hawaii itself runs the K-12 program) to a high of 49% in California (remnant of Proposition 13). It was 28% in Tennessee.

#### **Trends**

State aid to local governments as a percent of total spending has declined in recent years. One major reason is a dramatic increase in state spending on programs such as AFDC and Medicaid. The additional state spending on such programs,

---

<sup>11</sup>Based on a new survey by the National League of Cities (see Hoene and Pagano), the number of states that have cut aid in 2003 and 2004 is 24.

<sup>12</sup>A summary on state-local aid was presented in an article by Federal Funds Information for States (FFIS), October 2001.

while increasing total state spending, had a minimal effect on state aid. Thus while the percent of spending to aid local governments went down, the dollar amount generally increased.

### **Composition**

State aid consists of (1) categorical aid or grants which are generally restricted in how they can be spent (such as BEP aid or most of the gasoline and diesel fuel tax distributions to locals) and (2) unrestricted or general purpose aid (largest being amounts distributed to cities from state sales tax collections). Of the total amount of state aid to local governments, most is restricted (education, public welfare, highways and streets, health, housing libraries, etc.)

The distribution of state aid to local governments by category is shown in the report. With the exception of Hawaii, education represented the single largest category. Again much of the variations in aid by category reflect variations in service responsibilities between state and local governments.

### **Unrestricted Aid**

Unrestricted state aid (such as the portion of the state sales tax distributed to cities in Tennessee) to local governments has declined somewhat over the years from 8% in 1993 to about 7% in 1999. Unrestricted aid as a percent of total aid to local governments varied from a high of 74% in Hawaii to nothing in 8 states (Texas, Colorado, Missouri, Ohio, Delaware, Georgia, Kentucky, and Utah).

### **Local Requirements**

Local governments in many states are required to provide certain financial and administrative support for many state programs. Often state funds do not finance the full cost of such mandates or local responsibilities. The extent of such mandates varies extensively from state to state. With the exceptions of North Carolina and Virginia, southern states generally impose fewer participation responsibilities on local governments than in other states.<sup>13</sup>

<sup>13</sup>Federal Funds Information for States (2001), page 10.

## STATE TAX SHARING IN TENNESSEE

Tennessee uses four basic methods for distributing state-shared taxes.

1. **Situs or origin-based distributions:** Distributions of state taxes that are directly shared with local governments based on the situs (location) of the activity that was taxed or the situs or residence of the taxpayer. All of the following taxes are distributed on this basis: 17% wholesale beer tax,<sup>14</sup> Hall income tax, mixed drink tax, and coal and natural gas severance taxes.
2. **Population or per capita-based distributions:** To a certain degree, per capita-based distributions result in some revenue equalization among the recipients. All or portions of the following taxes are distributed on this basis: alcoholic beverage tax (part), city portion of the beer excise tax (whole), county portion of the gas and motor fuel taxes (part), sales tax (whole, with two exceptions), special petroleum products tax (whole), and TVA in lieu payments (part).
3. **Land Area:** Distribution is based upon the land area of a county. For example, portions of revenue from the gasoline tax (approximately 25.4%) and the motor fuel tax (approximately 17.5%) are distributed to counties for highway funding. One quarter of this distribution is based upon their land area. The assumption is that the larger a county's area, the larger its road network. All or portions of the following taxes are distributed on this basis: alcoholic beverage tax (part), county portion of the gas and motor fuel taxes (part), and TVA in lieu payments (part).
4. **Equal Shares:** local governments receive equal shares of the distribution, regardless of their collections or other factors. One-half of state gasoline and motor fuel tax collections shared with counties is distributed in even shares. All or portions of the following taxes are distributed on this

---

<sup>14</sup>The 17% wholesale beer tax is considered by some to be a local tax, not a state tax. For a discussion on the subject, see the history section of the report.

basis: county share of the beer excise tax (whole), and county share of the gasoline and motor fuel taxes (part).

- 5. **Other Basis:** two taxes are distributed in unique ways: a portion of corporate excise tax collections is shared with cities and counties on the basis of bank location and bank deposits; and a portion of TVA in lieu of tax payments shared with county governments is distributed based on a county’s share of total TVA property in the state.

Table 2 provides a detailed description of currently shared state taxes, the amounts involved during fiscal year 2002-03, and the method of distribution.<sup>15</sup>

**Table 2. Distribution of State-Shared Taxes with Local Governments, FY 2003**

<b>Tax</b>	<b>Amount Shared</b>	<b>Distribution Recipient</b>	<b>Formula Determining State Revenue Shared</b>	<b>Distribution Basis</b>
Alcoholic Beverage	\$5.5 million	Counties, Selected Cities	After a \$.04 per liter spirits share of tax to a distiller’s home county (Moore & Coffee), 17.5% of the balance of spirit and wine gallonage taxes to counties. From the county distribution, \$192,000 is earmarked for UT-CTAS.	<b>Population and Land Area.</b> County share is based ¼ on area and ¾ on population; 30% of the amount distributed to counties of more than 250,000 population having a contained city of 150,000 shall be paid to the city.
Beer Excise (\$3.90 per barrel)	\$3.3 million	Counties, Cities	10.05% to cities and 10.05% to counties.	<b>Population and Equal Shares.</b> Cities share on a population basis and counties share equally.

<sup>15</sup>Data supplied by the Tennessee Department of Revenue.

<b>Tax</b>	<b>Amount Shared</b>	<b>Distribution Recipient</b>	<b>Formula Determining State Revenue Shared</b>	<b>Distribution Basis</b>
17% Wholesale Beer Tax	\$101.5 million <sup>16</sup>	Counties, Cities	After 0.5% of tax for Dept. of Revenue and 3.0% of tax for wholesale vendor's compensation, the balance goes to local governments.	Situs of retailer making wholesale purchase.
Corporate Excise (Corporate Income Tax)	\$17.3 million	Counties, Cities	County and city amounts based on bank earnings in lieu of intangible personal taxes on banks and banking institutions.	Situs of deposits and level of property taxes.
Gasoline	\$228.5 million	Counties, Cities	Complex formula results in approximately 12.7% of total collections going to cities, and 25.4% to counties.	<b>Population, Land Area, and Equal Shares.</b> County share based ¼ on population, ¼ on county area, ½ is shared equally.
Hall Income	\$50.5 million	Counties, Cities	of tax goes to local governments.	<b>Situs.</b> Based on situs of taxpayer
Mixed Drink	\$18.3 million	Counties, Cities	Of the 15% gross receipts tax, ½ is returned locally.	<b>Situs</b> of collection
Motor Fuel	\$40.8 million	Counties, Cities	Approximately 8.8% of total collections to cities and 17.5% to counties.	<b>Population, Land Area, and Equal Shares.</b> County amounts based ¼ on population, ¼ on county area, and ½ is shared equally. City shares based only on population.

<sup>16</sup>Data for calendar year 2002; source: Tennessee Malt Beverage Association.

Tax	Amount Shared	Distribution Recipient	Formula Determining State Revenue Shared	Distribution Basis
Sales & Use	\$202.2 million	Cities	Approximately 4.3% after an allocation to the Transportation Equity Fund. Also a grant earmarked to UT-MTAS is from the cities share.	Population of cities.
Severance—Coal	\$.6 million	Counties	97% of tax collections to counties.	Situs of severance
Severance—Crude Oil & Natural Gas	\$.2 million	Counties	33% of tax collections to counties.	Situs of wellhead severance
Special Petroleum Products	\$12.0 million	Counties, Cities	Of a \$12,017,000 local government fund, about \$4.6 million is for county roads and \$7.4 million for city streets. Of the city share, an amount is earmarked for UT Center for	Population
TVA Payments	\$74.1 million	Cities, Counties	51.5% of TVA payments in excess of amount paid to state in FY 1977-78. Approx. 65.9% to counties, 28.3% to cities, and 5.8% <sup>17</sup> to TVA construction-impacted local areas.	<b>Population and Land Area.</b> County share based 43% on population, 43% on acreage, and 14% on TVA owned land; city share based on population.

Sources: Tennessee Code Annotated, TN Department of Revenue.

<sup>17</sup>The 5.8% of TVA funds distributed to TVA construction-impacted local areas is distributed in the following manner according to TCA 67-9-102:

If there is any money left over after the distribution of funds to impacted areas or there are no impacted areas, then the remaining money is distributed in the following manner:

- No more than 30% of the total impact funds is allocated to CTAS;
- If there are any remaining funds after the above distribution, then no more than 20% of the total impact funds will be distributed to TACIR for the infrastructure study;
- If there are any remaining funds after the above distribution, then no more than 20% of the total impact funds will be distributed to TACIR for other studies;
- If there are any remaining funds after the above distribution then the remaining funds shall be allocated to any regional development authorities that have acquired a former nuclear site from the TVA.

## STATE TAX SHARING HISTORY<sup>18</sup>

The sharing of taxes in Tennessee (at least in concept) is as old as the State’s second Constitution. The Constitution of 1834 provided that:

“It shall be the duty of the General Assembly, in all future periods, of this Government, to cherish literature and science. And the fund called the Common School Fund, and all the lands and proceeds thereof, dividends, stocks, and other property of every description whatever, heretofore by law appropriated by the General Assembly of this State for the use of common schools, and all such as shall hereafter be appropriated, shall remain a **perpetual fund**, . . . ”<sup>19</sup>

Early examples of state-shared taxes in Tennessee include the sharing of state poll taxes (as early as 1883), auto registration fees, and the sharing of gasoline tax revenue soon after the tax was first passed (in 1923).

### GASOLINE AND DIESEL FUEL TAXES

The original state gasoline tax was earmarked solely for the state highway department (for highway construction and maintenance), but diversion to other uses slowly appeared. Diversion first appeared in the form of grants to local governments for road use, and later for

**Table 3. Tennessee Tax Rate History**

Gasoline		Motor Fuel	
Tax (cents) (per gallon)	Effective Date	Tax (cents) (per gallon)	Effective Date
2	1923	7	1941
3	1925	8	1963
5	1929	12	6/1/1981
7	1931	14	6/1/1986
9	6/1/1981	15	6/1/1987
12	7/1/1985	16	4/1/1989
16	6/1/1986	17	4/1/1990
19	4/1/1989		
20	7/1/1989		

Source: Tennessee Department of Revenue

<sup>18</sup>Some of this material is taken from the TACIR publication *State-Shared Taxes in Tennessee*, p. 52.

<sup>19</sup>*A Financial History of Tennessee Since 1870*, page 7.



non-highway bond retirement and even for current state government operating expenses. In 1925, the tax was increased to 3 cents, and in 1929 increased by 2 cents to 5 cents. One cent of the two cent tax increase of 1929 was earmarked to county governments. The original distribution of State Aid Funds to counties was (1) 50% based on area and (2) 50% based on population.

In 1931, the tax was increased to 7 cents per gallon, with 2 cents of the 7 cent tax earmarked to counties. The basis for distribution to counties was also changed. Chapter 45 of the Public Acts of 1931 set out the method for disbursing county aid funds that is still in use today, over 70 years later.<sup>20</sup> When the motor vehicle fuel use tax was first imposed in 1941 (7 cents per gallon with 2 cents earmarked for distribution to counties), the method used to distribute the county share was the same as first set out 10 years earlier for shared gasoline tax revenue.

Cities first became eligible for a share of the gasoline tax and motor vehicle fuel tax in 1953. Public Chapter 1 of the Public Act of 1953 provided cities with an appropriation equal to the proceeds of one cent of the state gasoline and motor fuel taxes. The distribution to cities was based on population.

### **HALL INCOME TAX**

While the original Hall Income Tax passed in 1929 (at a 5% rate) did not provide for any tax sharing with local governments, when rewritten and revised in 1931, it required that 45% of collections be earmarked for distribution to counties and cities.<sup>21</sup> While newspaper accounts at the time do not specifically note the reason for the tax sharing arrangement included in the rewritten and revised tax, there is some mention (in newspaper accounts of the Special Sessions of 1931) of concern on the part of some lawmakers that other changes associated with passage of the Hall Income Tax (notably the exclusion of some intangible property from ad valorem taxation) would cause some reduction in local

---

<sup>20</sup>Of the total amount allocated to counties, 50% is distributed evenly to the 95 counties, 25% based on area, and 25% based on population.

<sup>21</sup>Chervin, Stanley, and Harry Green, 2003. *Hall Income Tax Distributions and Local Government Finances*. Draft of paper completed for TACIR and presented at August 28 meeting in Nashville, August 2003.

property tax collections. This “concern” may be the explanation for the tax sharing requirement built into the revised tax law.

### ***STATE SALES TAX DISTRIBUTION TO CITIES***

When the state sales tax was first passed in 1947,<sup>22</sup> 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.<sup>23</sup> The sharing of state sales tax revenue with cities has continued over the years.

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:<sup>24</sup>

- 70% (of collections) be used for education, most of which, at the time, was provided by county governments,<sup>25</sup> and
- that if revenue collections exceeded \$20 million in any fiscal year, the excess was to be distributed 80% among the counties,<sup>26</sup> 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<sup>27</sup> soon generated some

---

<sup>22</sup>Chapter No. 3, Public Acts of 1947. The act clearly stated that one of the reasons for the new sales tax was to help provide revenue to cities who, according to language in the Act, were facing “a financial crises.”

<sup>23</sup>“in proportion as the population of each municipality bears to the aggregate population of all cities within the state...”, Chapter 3, Public Act of 1947, Section 15.

<sup>24</sup>Public Chapter 3 of 1947, Section 15.

<sup>25</sup>While many fiscal relationships and responsibilities have changed since 1947, it is important to note that almost 80% of Tennessee BEP funds are distributed to county governments and not city governments.

<sup>26</sup>The actual language used specified that the distribution to counties was to be the same as used to allocate “two cents county gasoline tax.” Since the distribution of 2 cents of the state gasoline tax as worded in 1931 was based on three factors (50% distributed equally among all counties, 25% based on area, and 25% based on population), there is some ambiguity regarding the exact basis for the allocation of the excess sales tax to counties.

<sup>27</sup>In a few counties (primarily those which contained very large cities), a portion of the surplus funds received by the county had to be shared with the large city.

criticisms. Cries of an “unjust and indefensible situation”<sup>28</sup> arose when studies showed that some rural areas were receiving (on an A.D.A. and per capita basis) 10 times the amounts received by metropolitan areas.<sup>29</sup>

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 amounts distributed to city governments have grown dramatically over the years. During fiscal year 1995, \$147 million was distributed to cities. By fiscal year 2003 that number had grown to \$202 million (a 37.4% increase over 8 years).

### ***PREMIER TYPE TOURIST RESORTS***

From 1947 through 1979, the distribution of state sales taxes to cities was based on a city’s pro rata share of the total city population in the state. In 1979, the Legislature provided for an exception to this standard calculation for what was termed “premier type tourist resort” cities.<sup>30</sup> The original definition of “premier type tourist resort” in 1979 applied only to the City of Gatlinburg. The nonstandard distribution allowed a “premier type tourist resort” to receive 4.5925% of the actual amount of state sales tax collected within its borders rather than a share based on its relative population. Since Gatlinburg’s population is relatively small, the nonstandard distribution calculation produced significantly more than the standard distribution based on population. The additional amount distributed to Gatlinburg (above what it would have received from the standard distribution) was taken from the State General Fund.

The amount made available to Gatlinburg was increased again in 1984.<sup>31</sup> With this change, Gatlinburg became eligible for an additional share equal to 4.5925% of state sales tax revenue

---

<sup>28</sup>Thorogood, p. 180-181.

<sup>29</sup>Repeated from TACIR (March 2000), p. 52.

<sup>30</sup>Public Chapter 364 of 1979.

<sup>31</sup>Public Chapter 956 of 1984. This Act provided for a separate distribution of 4.5925% to any “premier type tourist resort” city that also owned a golf course and ski slope. Again, Gatlinburg was the only city that fit the narrow definition.

collected within its city limits, for a total of 9.185%. In 1986, Pigeon Forge was added to Gatlinburg and became eligible for the nonstandard distribution. Public Chapter 727 of 1986 added language to the law that allowed “premier type tourist resort” cities with “a theme park of not less than 80 acres” to be eligible for the same distribution as Gatlinburg (a distribution equal to 9.185% of state sales taxes collected within its city limits). The amounts distributed to both Gatlinburg and Pigeon Forge were increased again by Public Chapter 1025 of 1988. The additional amount to be distributed to each city was based on the dollar amount each city received during fiscal 1987 from one of the two 4.5925% shares already authorized.

The impact of this final additional distribution was to raise the amounts these two cities received in FY 1990 to approximately 13.3% of total state sales taxes collected within their borders. The additional amounts provided by Public Chapter 1025 of 1988 were to expire on July 1, 1991. However the expiration of the additional amounts never took effect since the expiration date was repealed by Public Chapter 463 of 1991. As the state’s fiscal position continued to deteriorate during the late 1990s, pressure mounted to limit the growing level of special distributions going to these two cities. Finally in 2000, legislation was passed that capped the amounts to be distributed to these cities at their FY 2000 level.<sup>32</sup>

During fiscal year 2003, as a result of the nonstandard distribution mechanics to Gatlinburg and Pigeon Forge, Gatlinburg received \$2,080,560 (\$1,877,088 more than its standard pro rata entitlement of \$204,472) and Pigeon Forge \$3,468,451 (\$3,157,287 more than its pro rate entitlement of \$311,164).<sup>33</sup>

### ***TVA DISTRIBUTION TO CITIES AND COUNTIES***

The Tennessee Valley Authority makes in lieu of tax payments to the State of Tennessee (and other impacted states) as required

---

<sup>32</sup>Public Chapter 983 of 2000.

<sup>33</sup>As a basis for comparison, Nashville, which generates 26% of all tourism sales, had it been eligible for a distribution calculated on the same basis as Gatlinburg and Pigeon Forge, would have received approximately \$57 million in FY 2000, instead of the \$24.6 million that it actually received.

under Section 13 of the Tennessee Valley Authority Act of 1933.<sup>17</sup> The level of the in lieu of tax payments is equal to 5% of its gross power proceeds. The total tax is distributed to the several states in which TVA operates on the basis of a formula that considers both power sales and property.

Until 1978, most of the payments received by Tennessee from TVA were earmarked to the State General Fund. In fiscal year 1978, that changed. Public Chapter 181 of 1977 (known as the Tennessee Revenue Sharing Act) changed the distribution to the following:

Effective for the fiscal year beginning July 1, 1978, any increase in TVA payments to the State of Tennessee over the amount paid during fiscal year 1977-78 (\$55.2 million) was to be distributed as follows:

- 48.5% to the State General Fund
- 48.5% to counties and cities
- 3% to impacted local governing areas (areas impacted by ongoing TVA construction activity)

The distribution of TVA funds to counties and cities was based on the following:

- 30% paid to counties on the basis of total county population (in relation to total state population)
- 30% paid to counties on the basis of acreage (relative to total state acreage)
- 10% paid to counties on basis of land owned by TVA in each county relative to total land owned by TVA in Tennessee
- 30% paid to cities on the basis of population (population of a city relative to population in all cities)

This formula clearly favored counties, and generally counties that were relatively large (by area) and/or that contained large areas

---

<sup>34</sup>48 Stat. 58-59, 16 U.S.C Sec 831.

of TVA-owned properties. The new distribution schedule most affected Stewart County, which at the time contained the TVA-managed Land Between the Lakes.<sup>35</sup>

### ***BANK EXCISE TAX DISTRIBUTION***

The current distribution is convoluted at best, and dates back over 25 years to 1977. Prior to 1977, certain cities and counties collected intangible property tax payments from commercial banks. While the tax was legally imposed on owners of bank stock, the banks, for the convenience of their shareholders, customarily made the tax payments to the various local governments that levied and collected this tax. The tax was not uniformly administered across the state.

As a result of its uneven application and administration, and the results of formal studies undertaken to evaluate the problem and make recommendations for change, the intangible tax on shareholder stock was repealed and replaced with a tax on bank net earnings in 1977.<sup>36</sup> The tax was set at 3% of net earnings<sup>37</sup> and was payable to local governments. The new tax contained various complicated elements designed to assist in establishing certain minimum levels of taxation and the methods to be used to distribute the tax due among the various local governments in which a bank operated. It was a complicated scheme designed to hold-harmless, as much as possible, local governments from the repeal of the intangible tax on bank shares.

Unfortunately, in 1983, the new tax was declared unconstitutional by the United States Supreme Court<sup>38</sup> and repealed. In response, the state, in a move designed to compensate local governments for this loss of revenue, extended the corporate income tax (Excise Tax) to banks and financial institutions and earmarked a portion (tax paid by financial institutions) to local governments (the

---

<sup>35</sup>This National Recreation Area is now managed by the U. S. Forest Service. Stewart County still benefits from the Land Between the Lakes property in the calculation of the distribution of TVA funds.

<sup>36</sup>Chapter 140, Public Acts of 1977.

<sup>37</sup>The tax provided a credit equal to 10% of ad valorem taxes paid on real and tangible property.

<sup>38</sup>*Memphis Bank & Trust Co. v. Garner*, 459 U.S. 392 (1983).



distribution to cities and counties is a time-consuming process currently administered by the Department of Revenue and the Office of the Comptroller).

### ***BEER EXCISE TAX***

This tax was first imposed in 1933 at a rate of \$1.20 per barrel. The original earmarking provisions called for one-third to be distributed to the state general fund for education, one-third to counties on an equal basis (for education), and one-third to cities based on population. In 1937, the tax was raised to \$1.70 per barrel with the additional revenue earmarked to the state general fund and the education restrictions in the law removed. The tax was raised in 1947 to \$3.40 with the new revenue earmarked to the general fund and raised again in 1981 to \$3.90 per barrel with the new revenue earmarked for litter control.

### ***ALCOHOLIC BEVERAGE TAXES***

Taxes on spirits and wine were first imposed in 1939. The tax on spirits was 70 cents per gallon and the tax on wine 25 cents per gallon. Fifty percent (50%) of the revenue was earmarked to counties and distributed 75% on the basis of population, and 25% on the basis of county area (the county revenue was earmarked for “old age security fund”). The tax was increased in 1943 to \$1 per gallon on spirits and \$.35 per gallon on wine, with all additional revenue earmarked for the benefit of the state, and raised again in 1947 to \$2 per gallon on spirits and \$.70 on wine. The additional revenue resulting from the 1947 tax rate increases was shared with counties and restrictions on the use of the county revenue removed. Additional increases occurred in 1963, tax on spirits increased to \$2.50 per gallon and in 1967 tax on spirits was raised to \$4.00 per gallon and tax on wine to \$1.10 per gallon. New revenue from the tax increases in 1963 and 1967 was earmarked for state general fund use only.

### ***MIXED DRINK TAX***

Chapter 211, Public Acts of 1967 imposed a tax at the rate of 15% on sales of alcoholic beverages for consumption on the premises (mixed drink and wine sales). The tax is distributed 50% to the state (earmarked for education) and 50% to local political



subdivisions.<sup>39</sup> Fifty percent (50%) of the amount distributed to local political subdivisions (presumably on the basis of where collected) was earmarked for education and distributed in the same manner as the county education property tax, and 50% distributed on the basis of where collected (by situs). The current distribution remains essentially unchanged, with the exception of language that provides for special treatment for 50% of taxes collected in “premier tourist resorts.”

### **17% WHOLESALE BEER TAX<sup>40</sup>**

The 17% wholesale beer tax is commonly considered a local tax since most of the revenue from the tax is distributed back to local governments based on the situs of the retailer making the wholesale purchase. In fact, the tax is levied by state law, not local ordinance.

This “ownership” controversy is best understood from the tax’s history. Chapter 37, Public Acts of 1951, authorized local governments to impose a tax (not to exceed 10%) on the retail sale of beer. The tax proved difficult to administer at the local level and was repealed in 1953. It was replaced with a state tax of 17% on wholesale sales of beer.<sup>41</sup> The tax is administered by the Tennessee Department of Revenue with most of the tax collected (96.5%) being distributed back to cities and counties based on the situs of the retailer making the wholesale purchase.<sup>42</sup> The 17% wholesale beer tax produces a significant amount of revenue for local governments. During 2003, \$101.5 million was distributed to local governments (17.8% to counties and 82.2% to cities).

---

<sup>39</sup>The original language is somewhat ambiguous on the meaning of “local political subdivision.”

<sup>40</sup>This description is repeated from TACIR (August 2002), page 21.

<sup>41</sup>Chapter 76, Public Acts of 1953.

<sup>42</sup>The Department of Revenue receives .5% for its administrative cost and wholesalers retain 3% for compensation for their administrative costs.

## STATE TAX SHARING PRINCIPLES: THE ISSUE OF FAIRNESS

Existing tax sharing arrangements in Tennessee should be evaluated not only by reference to the original or historical circumstances that existed at the time the arrangements were legislated, but also with some appreciation for the various services and service levels that local governments support. For some tax sharing arrangements, little or no relationship exists between the current level of funding and local government service levels. Principles and goals of tax sharing should recognize the following considerations that have affected current revenue-sharing programs in Tennessee:

1. Recognition that delivery of certain services requires a state-local partnership.
2. The need for a fiscal strategy to preserve the decentralization of public authority and functions between state and local governments.
3. Compensation to local governments for property exempted from local taxation or removed from tax rolls.
4. Compensation to local governments for performance mandated by state government.
5. Fiscal support for local governments for state restrictions placed on potential local revenue sources.
6. The need to provide some help to local governments whose size, administrative capacity, and small tax base may prevent the adequate provision of public services.
7. To promote equity and fairness in the provision of local public service. [Note: This is an elusive and amorphous goal and has not been articulated in any statute.]
8. As a matter of policy, tax sharing may be provided to keep local property taxes as low as possible.
9. Political arrangements that reflect historical competition between urban and rural interests.

10. The need to establish and maintain a state-local highway system and other transportation forms.

It should be noted that there is no formula to allocate proportions of state-shared taxes that might be covered by each of these principles or goals. For example, it is not possible to explain how much of the \$653 million distributed in FY 2003 relates to state mandates imposed on local governments, or for equity, or for any other principle.

### ***THE ISSUE OF FAIRNESS IN STATE-SHARED TAXES***

Any discussion of tax burden usually concludes with an admonition that it be “fair and equitable.” Webster’s Dictionary defines “equity” (or equitable) as: “fairness; impartiality; justice.” Fairness, of course, is used in many different ways, but in this context the general word “implies the treating both or all sides alike without reference to one’s own feelings or interests.”

The concepts of “fairness” and “equity” are applied to many different situations. These concepts may, but do not necessarily imply equality. The concept of “horizontal equity” implies equality; that is, that equals are treated equally. The concept of “vertical equity” however, implies the opposite; that is, that unequals are treated unequally, because of different needs. For example, one clear implication of the small schools lawsuit decision is that school systems must be held accountable for their ability to pay, that is, unequal tax bases mean unequal contributions. This is deemed necessary in order to provide an equal education to each student in each county.

When these concepts of “fairness” or “equity” are applied to state-shared taxes, it is with a great degree of ambiguity. For example, if the purposes(s) of state-shared taxes is broadly to assist in the funding of local governments, what criterion of “fairness” shall be applied?

### ***SOME EQUITY ISSUES TO BE CONSIDERED***

- Should each distribution formula be evaluated on some standard of equity or only the aggregate result?
- Is population a useful equity standard? If so, does it have limitations?

- Should equity considerations be based on cities compared to counties or on a county area basis (combined geographic fiscal impact of state aid)?
- Should considerations of equity in state-shared taxes be reviewed similarly to K-12 equity considerations?
- Can the State meet the goals of both horizontal equity and vertical equity in the distribution of state-shared taxes?
- If the distributions of state funds are intended to serve the purposes of State policy, is equity always a consideration?

### ***TAX SHARING PRINCIPLES AND THE TAX MODERNIZATION AND REFORM COMMISSION<sup>43</sup>***

A thorough and exhaustive investigation and evaluation of state-local fiscal relations occurred as a result of the creation of the Tennessee Tax Modernization and Reform Commission (TTMRC) in 1972. Chapter No. 746 of the Public Acts of 1972 created the TTMRC

“ . . . to study the alternatives to present state and local tax structures in the State of Tennessee. The areas of study shall include alternative methods of financing public school systems; the fiscal relationship between the state and local governments; the fiscal relationship between the state and the federal government; methods by which the state and local tax structure could be made responsive to economic growth; and methods by which the state and local tax burden could be distributed more equitably.”<sup>44</sup>

Given such a broad mandate, it is not surprising that much of the TTMRC’s work was related to the overall question of state aid to local governments, especially assistance in the area of financing local education. The TTMRC addressed this challenge from two different directions: it separately addressed (1) the overall problem of financing public school education and (2) the related but separate question of general state financial support to local governments.

<sup>43</sup>This section of the report is repeated from TACIR’s March 2000 report, pp. 52-54.

<sup>44</sup>Chapter No. 746, Public Acts, 1972.

Most of the tax-shared funds were, and still are, unrestricted; the most important exception being shared highway taxes. To a large extent, the types of such aid and the method for their distribution have not changed much since 1973 when analyzed by the TTMRC.

Since the TTMRC felt that the purpose of state-shared tax revenues should be to help local governments finance general local government needs, the Commission made the following finding:

“ . . . equitable method of distribution should be related to the needs of the local governments, as estimated from various economic and demographic indicators, for example, population, income, area, and miles of road. In this way, more aid should be distributed to those government units in which the estimated needs are greater.”<sup>45</sup>

In addition to considerations of actual need, the TTMRC felt that additional considerations should include measuring both the ability of local governments to raise their own revenue (tax ability) and their actual effort relative to their ability (tax effort) to do so.

The TTMRC asked its staff to evaluate various distribution methods and provide comparative data on distributions that would result. These distributions were then compared to actual distributions based on then current law. The TTMRC’s recommendations in this area of state and local relations were as groundbreaking as their recommendations for changes to the overall tax structure. The TTMRC’s recommendations included the following:

### **TTMRC Recommendation 7**

Repeal all current tax sharing arrangements involving the state sales tax, income tax, beer tax, and liquor taxes, and replace them with a program of general revenue sharing of the state sales tax. The TTMRC felt that the sales tax base would provide those sharing in the distribution with a more elastic source of revenue than was being provided by the various taxes that local governments then shared. The new general revenue-

---

<sup>45</sup>TTMRC (1973a), page 151.

sharing program would distribute funds to both cities and counties.

### **TTMRC Recommendation 8**

The amounts to be shared in Recommendation 7 should be distributed using a single formula that takes into consideration need, ability, and effort. The relevant variable used to measure need should be population. The measurement of ability should be based on an index that reflects a county's ability to pay as measured by its personal income and taxable property base. Its effort should be measured by its relative taxing effort versus the state average effort.<sup>46</sup>

Since the recommendations of the TTMRC were made in the context of an overall dramatic overhaul of the state tax structure, including a personal income tax, additional revenues were expected as part of the changes recommended. Because of this the TTMRC also recommended that, given the two recommendations above, additional funds be used to hold harmless any local governments that would otherwise suffer from their recommended new distribution of shared-tax revenues.

### **TTMRC Recommendations 11-14**

The TTMRC recommended several items related to distributions of gasoline and motor fuel taxes. Their recommendations included continuation of the distribution of 2 cents of the state highway fuel taxes to counties. However, they noted a clear dissatisfaction with a distribution dominated by the requirement that sent 50% of all county highway funds to counties on an equal basis. This clearly discriminated against urbanized areas. They always recognized a problem with a program that provided the equivalent of a 2 cent tax to counties but only 1 cent to cities. In response they recommended that the funds distributed to counties should be immediately changed to a formula based equally on population, area, and equal shares. Future growth in county highway funds should be distributed on the basis of population. The combination of these two elements would have been a slowly phased-in change

---

<sup>46</sup>A full description of the distribution formula recommended is contained in the Appendix.

to minimize any sudden dramatic fiscal impact on county highway programs. For cities, they recommended new funds equivalent to a 1 cent gasoline and motor fuel tax. These new funds would be distributed on the basis of population and not be earmarked for any specific use (TTMRC Recommendation 14).

In general, the TTMRC recommended long-run shifts in the distribution of highway money for local governments from one based on a combination of equal shares, land area, and population, to one based on population only.

Other recommendations, principles, and concerns of the TTMRC that involved state-local tax sharing issues included:

- The State government does have a responsibility to assist local governments in funding local services.
- Transferring funds among levels of government can improve tax equity. Intergovernmental transfers can be used to substantially equalize the tax burdens among individual taxpayers and provide to all taxpayers state-local tax burdens that relate to ability to pay. The Commission considered that “allowing local governments to add local rates to state taxes merely favors the localities with high tax bases. A reasonable solution, then, seems to be that there must be some transferring of funds from one governmental subdivision to another by the state tax system. In other words, the state might choose to use its taxing powers more extensively or intensively and provide funds to particular taxing jurisdictions in ways that would equalize tax burdens.”<sup>47</sup>
- Local taxpayers must exert a reasonable effort to support locally provided services before the state should be expected to provide any subsidy or supplement. While state supplementary aid is appropriate for some local services, state funds should not be used to supplant a reasonable local effort.

---

<sup>47</sup>TTMRC (1973), p. 69.



- In some situations, additional state aid may be conditioned on reduced local tax burdens.<sup>48</sup>
- Any negative impact of changes in distribution formulas may be softened by phasing-in changes over time.
- To better evaluate local needs, local effort, and local ability, the state should provide for the collection of social, economic, and fiscal data for cities and counties on a continuing basis.
- One of the many recommendations made by the TTMRC that is as important today as it was back then was the following: “Allow local units substantial authority for raising revenue from their own sources, but make it abundantly clear that local taxes are the responsibility of local public officials and taxpayers.”<sup>49</sup>

### ***LESSONS FROM THE FEDERAL GENERAL REVENUE SHARING PROGRAM***

The U.S. General Revenue Sharing Program that existed from 1972 through 1986 is an example of federal intergovernmental sharing of revenues and offers some insights and guidance for state tax sharing programs. This “New Federalism” program was initiated by President Richard Nixon as a reaction to what was perceived to be an increasing centralization of responsibility and authority at the federal level at the expense of state and local government autonomy.

Through the “State and Local Fiscal Assistance Act of 1972,” the Federal Government allocated and distributed a set annual amount of federal funds automatically by formula to all state and local governments. This “new federalism” allowed state and local governments, within broad reporting and anti-discrimination requirements, to spend these funds as they saw fit. The General Revenue Sharing program was in addition to various categorical grant programs.

---

<sup>48</sup>TTMRC (1974b) p. 2. Specifically, “any increase in state financial assistance to local jurisdictions will be accompanied, when practicable, with directive to reduce local tax burdens correspondingly.”

<sup>49</sup>TTMRC (1974b), pp.4-10.

The distribution of General Revenue Sharing funds to over 39,000 state and local governments was based on population, income, and tax effort. The formula rewarded more, on a per capita basis, low income local governments and those governments that helped themselves through higher tax efforts. Funds were first allocated to each state based on these factors. State governments retained one-third of the funds and two-thirds were set aside as general purpose aid to local governments. To insure that a local government did not receive an inordinately large share of funds while another government received almost none, the act contained restrictions on the minimum per capita amount a location could receive (no less than 20% of the average per capita amount available for distribution) and the maximum per capita amount (not to exceed 145% of the average per capita amount available for distribution to all local governments in the states). In addition, no local governments could receive more than 50% of the sum of its adjusted taxes (total taxes excluding tax revenues used for educational purposes) or any payment of less than \$200.<sup>50</sup>

The intrastate allocation process began with a tiering process of dividing funds among geographic county areas. Funds were allocated to counties using population, income, and tax effort. Once the total county allocation was established, separate amounts were set aside for any Indian tribes based on their percentage of a county's population. The county level government then received a proportion of the remaining funds based on the percentage of its adjusted taxes (total taxes excluding tax revenues used for educational purposes) compared to all local governments in the county. Cities and townships located in the county then received their entitlement based on their population, relative income, and tax effort compared to other cities and townships in the county area.

The U.S. General Accounting Office conducted several reviews of the General Revenue distributions over the years of the program.<sup>51</sup> They concluded that although the Revenue Sharing Act formula based on population, income, and tax effort provided

---

<sup>50</sup>The recommendations of the TTMRC also contained restrictions on aid that were related to a similar definition of adjusted taxes. See TTMRC section in Appendix.

<sup>51</sup>U.S. GAO reports, 1980.

a reasonable approach for allocating funds, geographic tiering procedures used in applying the funds caused differences in payments to local governments with similar populations and fiscal efforts within a given state.

The experience of the General Revenue Sharing program highlights the importance of the factors used to distribute shared revenues. Also, any formulas proposed need to be analyzed to determine if there are any inherent inequities that may result and whether any such inequities or anomalies serve the public interest.

### ***REVENUE SHARING CASE STUDY: REVENUE SHARING IN MICHIGAN***

Beginning in fiscal year 1998-99, the State of Michigan fundamentally revised the way the State distributed revenue sharing payments to local governments. Michigan began sharing a portion of its state sales tax with local governments based on formulas that consider need (population and population unit type), fiscal capacity, and fiscal effort with some consideration of stability in the amount of revenue received. Under the old distribution formula, local governments tended to receive more if their taxes were relatively high, while under the new distribution mechanism a wide variety of factors affect how much a local government will receive, with population being the most important factor.

The Michigan revenue sharing program is funded from two sources: (1) constitutionally, 15% of sales tax collections at the 4% rate (an additional 2% sales tax is dedicated to education) is distributed to cities, villages, and townships on a per capita basis; (2) statutorily, up to 21.3% of the 4% sales tax as appropriated by the legislature is divided between counties and the other local governments. Michigan includes 83 counties, which are divided into townships (1,240); some areas have incorporated cities (273) or villages (263) to provide a higher level of service but may still receive some services from the county or township. Counties receive 25.06% of the “statutory funds,” which are distributed on a per capita basis. Cities, villages, and townships receive the remaining 74.94% based on the formulas or calculations as follows:

1. **Percent Share of FY 1998:** This factor is not actually part of the new three formulae method that became effective in fiscal year 1999. It is part of the old statutory method,

but is being phased-out slowly (to be fully phased out in 2008) to avoid any sudden and unanticipated disruptions in the level of expected state aid to local governments. After 2008, payments to local governments will be based on the following formulae (one-third of the total amount to be distributed per each method).

2. **Taxable Value per Capita Share (Formula):** This factor is a gauge of a community's ability to raise revenue (fiscal capacity or wealth). It uses the ratio of the statewide taxable value per capita to each unit's taxable value per capita. Property taxes represent the primary own source revenue for local units in Michigan. A unit with taxable value below the state average will produce a ratio (weight) greater than 1 and a unit above the state average will produce a ratio (weight) less than 1. The factors are then multiplied by a unit's population to arrive at a unit's weighted population. Each local governmental unit will then receive an amount equal to the ratio of its weighted population to the total weighted population of all units, times the amount available for distribution.
3. **Population Unit Type Share (Formula):** Part of the distribution is based on a population-weighted calculation that is designed to measure local government service needs. Service needs are statutorily established as a function of population size and local government type (village, township, or city). Population factor weights vary from 1.00 for a township with a population of less than 5,000, to a high of 10.75 for cities with populations that exceed 640,000.<sup>52</sup> Townships that provide services similar to those provided by cities receive a weight factor equal to a city. For example, a city with a large population has a higher weight than a city with a lower population and a city has a higher weight than a village or township of similar size. Some exceptions to the weights are allowed for townships providing a higher level of service to follow city weights. ("A township that "makes available fire and police on a 24-hour basis either through contracting for or directly employing personnel, AND water to 50% of its residents AND sewer to 50% of its residents"

---

<sup>52</sup>See Appendix for full weighting scheme.

AND has a population of 10,000 receive a city weight factor.) This factor also incorporates total population minus patients, convicts, and wards in public tax-supported institutions. Each unit receives an amount calculated by multiplying the ratio of its weighted population to the total state weighted population by the amount available for distribution for this method.

4. **Yield Equalization Share (Formula):** The purpose of this formula is to offset variances in taxable property wealth among local units. It is a measure of fiscal capacity as well as effort. Based on funds available to fund this formula, a guaranteed tax base is established. A local unit receives revenue sharing according to the amount its local property value per capita is below the guaranteed tax base and the amount of local revenue it manages to collect for itself. The local tax effort is equal to total local taxes (property, income, excise, other assessments) per capita divided by its taxable value of property in the local unit. This is equivalent to an effective tax rate. The formula is intended to equalize the return for each “mill” (\$1 for each \$1,000 of taxable value of property) in taxes levied up to a maximum of 20 mills. In 2003, local units having a taxable value per capita of more than \$24,269 will probably not receive a yield equalization payment.
5. **Eight Percent (8%) Cap Payment:** Local units of government are limited to an 8% annual increase in revenue sharing payments with some exceptions for high population growth. Funds in excess of the 8% are redistributed to areas with the smallest growth to provide some stability to the payments from year to year.

The full effect of this policy change has not been seen because the formulas have not been fully funded, which has resulted in fewer funds actually distributed through the new formulas. In the midst of budget reductions last year, FY 2004 distributions to cities, villages, and townships is expected to be 97% of revenues received from the distribution of FY 2003. As a result of these implementation changes, revenue sharing payments to local governments are still uncertain and fluctuate from year to year.

## RECENT STUDIES ON TAX SHARING IN TENNESSEE

### ***TACIR: STATE-SHARED TAXES IN TENNESSEE***<sup>53</sup>

A study of state-shared taxes during 1999 and 2000 was the direct result of state fiscal belt-tightening that was forced upon the state by a combination of a slowing economy and Tennessee's chronic fiscal problems caused by its inelastic tax structure. Numerous fiscal strategies discussed at the time included some cutbacks in state-shared taxes. This report provided detailed information on the significance of state tax sharing in Tennessee as well as detailed data on the possible fiscal effects of tax sharing cutbacks on county and city governments in Tennessee. The report included some information on the relative importance of state-shared taxes to local governments as well as a discussion of the work of the Tennessee Tax Modernization and Reform Commission discussed in a previous section of this report.

### ***MIDDLE TENNESSEE STATE UNIVERSITY (MTSU): SHARING TAXES BETWEEN STATE AND LOCAL GOVERNMENTS IN TENNESSEE***<sup>54</sup>

As part of TACIR's review of state-shared taxes in Tennessee, the Business and Economic Research Center at MTSU was asked to participate in the project by performing an independent analysis on the subject, with a special emphasis and evaluation of highway fuel tax sharing arrangements. Since the MTSU report included some detailed discussion of the existing tax sharing arrangement for the state motor fuel taxes tax versus alternative distribution arrangements, a brief summary of that material is included in this report.<sup>55</sup>

---

<sup>53</sup>TACIR, *State-Shared Taxes in Tennessee*, March 2000.

<sup>54</sup>Kyle, Reuben and Bichaka, Fayissa. 1999. *Sharing Taxes Between State and Local Governments in Tennessee*. A report submitted by the Business and Economic Research Center at Middle Tennessee State University to the Tennessee Advisory Commission on Intergovernmental Relations (TACIR). November 1999.

<sup>55</sup>For a full discussion of this topic, see report by Kyle and Fayissa (1999), pp. 34-47.



The MTSU review of motor fuel tax sharing first began with a review of such arrangements in neighboring states. The results of that review show the only state with a distribution scheme similar to that in Tennessee was found in Mississippi.<sup>56</sup> In several states, local governments receive no state aid since local governments are authorized to levy their own taxes on motor fuels.<sup>57</sup> The reader is cautioned that in many cases the variation in state-local tax sharing arrangements reflects variations in state-local responsibilities for highways, streets, roads, and bridges. In some states, the state government is fully or almost-fully responsible for all highway and bridge construction and maintenance. In such cases, little or no tax sharing is appropriate.

The authors go on to note various alternatives to the current gasoline tax sharing arrangements that were suggested by Quindry and Engels (1972) in a special report for the Tennessee Tax Modernization and Reform Commission. Quindry and Engels questioned the existing methodology for distributing gasoline taxes and noted the usefulness or appropriateness of other variables in distribution formulas or methods.<sup>58</sup> They evaluated the existing statutory gasoline tax distribution scheme and determined that the result was “other things equal, the most densely populated counties and the fastest growing counties in the state receive smaller relative shares of Tennessee’s gasoline and motor fuel shared tax revenues than other counties.”<sup>59</sup>

Kyle and Fayissa noted that the existing distribution of motor fuel taxes to counties allocates one-fourth of the total county-share of motor fuel taxes on the basis of land area while one-half of the total is simply distributed equally among the counties (regardless of population or mileage or traffic). In the case of one-half of the distribution, this means that Pickett County (the smallest) receives the same share as Shelby County (the largest). Not surprisingly,

---

<sup>56</sup>The distribution method used in Mississippi for counties is based partly on equal share, partly on rural miles, and partly on population.

<sup>57</sup>States include Alabama and Georgia.

<sup>58</sup>Such as measures of number of registered motor vehicles, volume of gasoline sales, population density, population growth rates, and highway mileage.

<sup>59</sup>Kyle and Fayissa (1999), p. 36.



counties with large land areas and low populations receive relatively large amounts of shared motor fuel taxes.<sup>60</sup>

The authors went on to analyze the impact of distributing motor fuel taxes using a formula based on road utilization or usage.<sup>61</sup> Using their new distribution formula and using actual 1995 distribution data, the authors determined that a distribution based on road usage would result in “a substantial reallocation of Tennessee’s fuel tax distribution.”<sup>62</sup> Distributions on a usage basis would be more likely to channel state-shared revenue to those areas with the greatest road usage and needs. To improve the equity of highway fuel tax sharing, they recommended that Tennessee consider reducing state highway fuel taxes (gasoline and motor fuel) and allow or require local governments to levy local gasoline taxes directly which would have to be done at retail level. While a tax at retail involves some administrative problems, taxes collected at retail and returned by situs would ensure that high vehicle usage areas received some local highway funds based on where vehicle use (and road use) actually occurred.<sup>63</sup>

---

<sup>60</sup>Counties that would be most impacted by a distribution based on road utilization versus the current scheme include: Clay, Grundy, Haywood, Jackson, Lewis, Marion, Perry, Smith, Van Buren, and Wayne. See data in Kyle and Fayissa, Table 11.

<sup>61</sup>A usage variable was constructed using data on county population (adjusted for commuters out and commuters in) divided by road mileage within the county (Kyle and Fayissa, page 41).

<sup>62</sup>Kyle and Fayissa, p. 41.

<sup>63</sup>No single method is perfect, including one based on retail sales. Clearly counties that include major highways, including state and federal interstate highways, would get credit for local gasoline taxes while having little responsibility for the roads that helped generate the taxes.

## TENNESSEE LOCAL UNITS OF GOVERNMENT

Tennessee has three major types of local government units responsible for the provision of what most consider local public services: counties, cities, and special school districts.<sup>64</sup> Tennessee also had (2002 data) 475 special district government entities, such as airport authorities, development agencies, disposal authorities, housing authorities, watershed districts, sanitary districts, soil conservation districts, utility districts, and others. Special districts, including special school districts, are not analyzed in this report.

Counties and cities are general-purpose local governments that provide a host of services to local residents; special school districts are exactly what their name implies, a special government unit organized to provide local education services only. Counties, cities, and special school districts all have the legal authority to levy taxes on residents (including businesses) within their boundaries to fund the provision of local services. Special school districts are limited to levying only property taxes, and are restricted to rates authorized in private acts by the General Assembly.

The primary unit of local government in Tennessee is the county. Many Tennessee residents receive the majority of their public services from county governments. Major services provided by county governments include public education, sheriff and fire services, roads and highways, health, and sanitation and solid waste services.

Cities are usually created to provide enhanced or new services for residents in high population density areas when sufficient demand for such public services is present. The additional services provided by cities generally include police and fire protection services (a supplement to county sheriff department and volunteer fire services), enhanced public education services, infrastructure improvements including streets, lighting, sewer and water, parks

---

<sup>64</sup>Based on the latest Census data (see U. S. Census, 2002), Tennessee had 92 county governments, 349 city governments, and 14 special school districts in 2002. City-county metropolitan governments are treated as cities by the Census and would include Nashville-Davidson County, Lynchburg-Moore County, and Hartsville-Trousdale County.

and recreation, parking, libraries, stricter building zoning control, and others. Cities generally pay for these additional services by imposing additional taxes on residents and businesses located within their boundaries. As a result, city services can vary substantially based on the degree of resident demand for these various additional services, and the local tax base available to fund such enhanced public services. Local governments, frequently through separate legal entities, often provide local utility services (water, sanitation, and electricity) to their constituents.

**FINANCING LOCAL GOVERNMENT ACTIVITY<sup>65</sup>**

Local governments finance their expenditures from three revenue sources: (1) intergovernmental aid provided by both the federal government and state government, and own source revenue which includes (2) locally imposed taxes, and (3) user fees and charges, and certain miscellaneous revenue sources. Table 4 shows the relative importance of each revenue source for fiscal years 1975, 1986, 1996, and 2000.<sup>66</sup> What is most surprising about the data in Table 4 is an absence of any significant change in the relative importance of state aid, despite significant recent increases in state categorical grants in support of local education (BEP program). The reduced importance of federal aid reflects both

the demise of federal revenue sharing that began in 1972 and ended in 1986<sup>67</sup> and an increase in federal aid channeled to local governments through the state government.

The data in Table 4 show a clear offsetting increase in the importance of local own source revenue. Most of the increase in own source

**Table 4. Tennessee: Distribution of Local Government General Revenue for Selected Years**

Revenue Source	1999-2000	1995-96	1985-86	1974-75
Federal aid	2.7%	2.6%	6.8%	10.0%
State aid	30.5%	29.9%	26.6%	31.0%
Own source revenue	66.8%	67.5%	66.6%	59.0%
Total	100.0%	100.0%	100.0%	100.0%

Source: U.S. Dept. of Census website and various issues of "Significant Features of Fiscal Federalism" by the ACIR.

<sup>65</sup>All local government taxing authority flows from the State Legislature. See Article 2, Section 29 of the State Constitution.

<sup>66</sup>Last year for which complete data is available.

<sup>67</sup>State and Local Fiscal Assistance Act of 1972. Program ended for state governments in 1984 and finally for local governments by 1986.

revenue was from current charges and miscellaneous revenue, not from increased local taxes. Local own source taxes accounted for about 36% of local general revenue in fiscal year 2000, little changed from its relative importance in the prior fiscal periods included in the table.

Table 5 shows fiscal data (1997) for cities only. The table requires some clarification since city finances by themselves involve some unique fiscal elements. Cities in many states receive revenue from higher levels of government, generally the county in which they are located. In Tennessee, the county-wide local option sales tax is shared with cities for two reasons: (1) 50% of local option sales tax revenue is shared among the school systems that operate within a county, and (2) the second 50% of local option sales taxes is distributed on the basis of where collected (situs based). In addition to sharing local option sales tax revenue in Tennessee, county imposed education property taxes are also distributed among the school systems that operate within a county, resulting in distributions in some counties to city school systems.

**Table 5. Distribtuion of City General Revenue (1997)**

State or Region	Federal Aid	State Aid	Other Local Aid	Own Source		Total
				Taxes	Charges & Misc.	
United States	5.3%	20.7%	2.3%	42.5%	29.2%	100.0%
Southeast	3.9%	15.3%	6.2%	40.7%	33.9%	100.0%
Alabama	2.1%	5.3%	2.9%	59.3%	30.4%	100.0%
Arkansas	1.4%	12.3%	10.6%	31.5%	44.1%	100.0%
Florida	4.1%	9.1%	3.0%	42.4%	41.3%	100.0%
Georgia	2.9%	3.4%	12.1%	38.7%	42.9%	100.0%
Kentucky	4.4%	7.2%	2.0%	44.6%	41.9%	100.0%
Louisiana	7.2%	8.8%	2.0%	48.4%	33.6%	100.0%
Mississippi	3.1%	27.0%	2.0%	22.5%	45.3%	100.0%
North Carolina	6.4%	12.6%	12.6%	30.7%	37.7%	100.0%
South Carolina	6.9%	8.7%	2.9%	49.2%	32.3%	100.0%
Tennessee	1.5%	24.2%	15.9%	32.6%	25.8%	100.0%
Virginia	3.9%	32.9%	0.7%	45.1%	17.4%	100.0%
West Virginia	3.7%	2.2%	0.2%	35.1%	58.8%	100.0%

Source: U.S. Census Bureau, *1997 Census of Governments, Vol 4, Government Finances, GC97(4)-4, Table 3.*

The high percentage of state intergovernmental aid reflected in the table for Tennessee and Virginia reflects the fact that cities in these two states operate some of the public school systems and therefore receive some of the state K-12 education aid. The high percentage in Mississippi is accounted for by the relatively high amount of unrestricted aid Mississippi provides to its local governments, including cities.

Table 6 presents data (for the same list of states) that reflects the extent to which state intergovernmental aid to cities, excluding school aid, is made available for general local government support. The data for 1997 (latest available) show that Tennessee, while not having the highest percentage of unrestricted aid, is well above average. The figure for Tennessee is higher than the average for the southern states included in the table as well as higher than the average for all states.

**Table 6. State Aid to Cities, by Type of Aid**  
(in thousands)

State or Region	Total State Aid	Education Aid	Net State Aid	General Support Only	Percent
United States	\$ 45,932,354	\$ 12,134,331	\$ 33,798,023	\$ 11,664,693	34.5%
Southeast	5,411,577	1,971,524	3,440,053	1,541,721	44.8%
Alabama	126,580	11	126,569	34,988	27.6%
Arkansas	130,693	0	130,693	46,381	35.5%
Florida	661,759	196	661,563	526,440	79.6%
Georgia	104,561	0	104,561	49	0.0%
Kentucky	110,509	0	110,509	18	0.0%
Louisiana	230,647	286	230,361	52,208	22.7%
Mississippi	333,887	0	333,887	280,673	84.1%
North Carolina	469,382	5,409	463,973	269,282	58.0%
South Carolina	81,319	0	81,319	60,173	74.0%
Tennessee	1,175,144	731,505	443,639	223,669	50.4%
Virginia	1,973,844	1,234,117	739,727	46,207	6.2%
West Virginia	13,252	0	13,252	1,633	12.3%

Source: U.S. Census Bureau, *1997 Census of Governments, Vol 4, Government Finances*, GC97(4)-4, Table 3.

## CITY GOVERNMENT IN TENNESSEE AND THE SOUTHEAST

As of July 2003, there were 348 incorporated cities in Tennessee. To put that number into perspective, Table 7 shows the number of cities in each of Tennessee's bordering states.

Tennessee has fewer cities per population than any contiguous state except Virginia.<sup>68</sup> The data in Table 7 also reflects that a majority of cities in all states included in the table are small (< 2,500 population).

**Table 7. Comparative City Data**

State	Population	Number of Cities	Number per 10,000 Persons	Percent with Populations <2,500
Alabama	4,464,356	451	1.010	69.6%
Arkansas	2,692,090	499	1.854	79.8%
Georgia	8,383,915	531	0.633	67.6%
Kentucky	4,065,556	424	1.043	71.2%
Mississippi	2,858,029	296	1.036	70.3%
North Carolina	8,186,268	541	0.661	65.2%
Tennessee	5,740,021	348	0.606	61.3%
Virginia	7,187,734	229	0.319	65.1%

Source: U. S. Census Bureau, *2002 Census of Governments*, Vol. 1, Number 1, Government Organization, Tables 3 and 7.

Tennessee's relatively low number of cities (per 10,000 persons) is largely due to a half-century of liberal annexation powers. Places that would have become incorporated in other states were annexed into existing cities in Tennessee. Fewer incorporations were in the public interest, and served the interests of existing cities when state-shared taxes were distributed.

Fifty-eight and one-half percent (58.5%) of Tennessee's population lives in cities and towns (our state draws no legal distinction between those designations). The city population ranges from Memphis, with 666,786 people, to Silerton, with only 60 residents.

<sup>68</sup>It should be noted that Virginia is somewhat unique in having a large number of independent cities (39) with the fiscal and spending patterns normally associated with counties.

Table 8 shows the distribution of Tennessee cities by population size. The five largest cities represent less than 2% of all cities, but they contain almost half of all Tennesseans who live in cities. At the opposite end, 33% of all the cities are under 1,000 population, but they account for only 2% of all city dwellers. If one adds the two smallest categories together, 60% of all Tennessee cities have populations under 2,500, and contain only 7% of the total city population.

**Table 8. Distribution of Tennessee Cities by Population Size**

Population Size	Number	% of All Municipalities	Population	% of Municipal Population
Over 100,000	5	2%	1,645,209	49%
50,000-99,999	3	1%	184,013	5%
25,000-49,999	12	4%	420,397	12%
10,000-24,999	28	8%	434,942	13%
5,000-9,999	39	11%	273,783	8%
2,500-4,999	49	14%	187,595	6%
1,000-2,499	95	27%	152,850	5%
Under 1,000	117	33%	58,463	2%
Total	348	100%	3,357,252	100%

Source: Municipal Technical Advisory Service (MTAS), University of Tennessee, "Directory of Tennessee Municipal Officials," September 2002.

Table 9 shows per capita expenditure levels for selective expenditure categories for all cities and for small cities (population < 10,000) in Tennessee and in each neighboring state.

**TABLE 9. Per Capita (\$) City Expenditures (FY 1997)**

State	All Cities				Cities With Less Than 10,000 Population			
	Highways	Police	Fire	Parks & Recreation	Highways	Police	Fire	Parks & Recreation
Alabama	83	134	82	67	70	119	45	35
Arkansas	87	109	63	33	69	84	28	14
Georgia	79	159	79	66	71	136	41	27
Kentucky	63	116	63	37	48	81	30	17
Mississippi	92	123	71	28	75	115	45	20
North Carolina	98	163	79	70	102	158	50	42
Tennessee	99	156	100	101	91	114	53	39
Virginia	109	149	83	76	115	130	26	32
Total	90	144	80	66	79	119	41	29

Source: COG 97 (September 2000), Table 13.



The data make clear that Tennessee cities tend to spend more per capita on the services listed in the table than the average for comparable cities (all cities as well as small cities) in neighboring states.

Table 10 shows that for all cities together, Tennessee per capita general revenue (\$1,597) was second only to Virginia (\$2,193).<sup>69</sup> Small city per capita general revenue was highest in Tennessee.

**Table 10. Selective Per Capita City Revenue (\$) by State (FY 1997)**

State	All Cities				Cities with Less than 10,000 Population			
	General Revenue	Revenue From State	Own Taxes	Own Charges & Misc	General Revenue	Revenue From State	Own Taxes	Own Charges & Misc
Alabama	928	49	551	282	724	64	358	268
Arkansas	683	84	215	301	482	90	182	168
Georgia	1,034	35	400	444	649	43	251	239
Kentucky	847	61	377	355	529	49	220	243
Mississippi	895	242	202	406	604	212	126	218
North Carolina	1,100	139	337	415	959	138	265	347
Tennessee	1,597	386	520	412	1,013	250	245	336
Virginia	2,193	721	990	381	1,009	234	485	239
Total	1,227	227	480	381	742	121	261	263

Source: COG 97 (September 2000), Table 13.

### **CITY GOVERNMENT IN TENNESSEE**

A city is a general purpose unit of local government, created under state law or charter, which is authorized to levy and collect taxes, borrow and expend monies, exercise police powers, and provide services for the welfare of its citizens. A city is, legally, a special type of corporation whose organization, powers, and responsibilities are specified by state statutes. It is created upon the initiative of local residents for their benefit, interest, and convenience.

From 1796 to 1953, every city that became incorporated in Tennessee was established by private act of the General Assembly. In 1953, pursuant to a constitutional amendment, legislation was enacted to establish several general law charters for incorporation

<sup>69</sup>See footnote 68.

and no cities or towns have been created by private act since that date. Table 11 shows the different forms of incorporation and the number of cities created under each.

**Table 11. Distribution of Cities by Form of Incorporation**

Form of Charter	Number	Percent
Home Rule	13	4%
Manager-Commission	51	14%
Mayor-Aldermanic	67	19%
Modified Manager-Council	2	1%
Metropolitan Government	3	1%
Private Act	212	61%
<b>Total</b>	<b>348</b>	<b>100%</b>

Source: Municipal Technical Advisory Service, 2002.

Why do residents of one area decide to become incorporated while others in areas with equal population and prospects never initiate such action? A lot of the answer has to do with expectations. When citizens are satisfied with the services they are receiving from the county and utility district (if any), they are likely to maintain the status quo. There are, after all, some disadvantages to

becoming incorporated. As a corporate entity, a city becomes subject to legal obligations and exposure to liability. Incorporation usually means losing certain county services such as law enforcement and street construction and maintenance. Forming a city is usually more expensive for those who choose to do it.

However, there are many advantages to incorporation. Reasons for incorporating include:

- To secure a higher level of services than the county or a utility district can provide;
- To control growth and maintain the character of the community through planning, zoning, and code enforcement;
- To prevent being annexed by an existing city;
- To establish a mechanism of local political control;
- To capture county revenues (local sales tax, beer tax, etc.) that are situs based and flow to the city after incorporation;
- To capture revenues in adjoining counties (34 cities are in more than one county);
- To sell liquor or beer; and
- To qualify for state-shared taxes that are distributed to cities.

It is possible for a new city government to finance its operations through the (former) county revenues it receives after incorporation or annexation, the half of the local sales tax that is not earmarked for schools, the revenues shared by the state with cities and towns, fees for licenses and inspections, and other miscellaneous revenues, without resorting to a property tax.

### ***CITY SERVICES AND STATE POLICY***

Many cities represent a significant step up from some default level of government that exists in every state. In Tennessee, the default level of local government is the county (supplied by the State Constitution and required to provide certain constitutionally mandated services).<sup>70</sup> Generally, but not always, cities are created to provide enhanced or augmented levels of service, beyond those offered by the default or county government and any special districts that may also exist.<sup>71</sup> The range of enhanced services varies extensively from city to city, as evidenced by the following material that details city services. An outstanding question that remains unresolved is to what extent and under what circumstances state government should subsidize or financially assist city governments. This issue has been partially addressed previously in Tennessee by various statutes.

### ***TENNESSEE GROWTH PLANNING LAW***

Controversy associated with small city incorporations during the 1990s, in addition to ongoing problems associated with annexations by existing cities, and other long-standing city-county growth and revenue issues, resulted in the passage of Public Chapter 1101 of 1998 (T.C.A 6-58-101 et seq.).

Since passage of this comprehensive growth planning legislation, the standards and requirements for incorporation are more stringent.

- Restricts new incorporations to planned growth areas.

<sup>70</sup>See following section on county services.

<sup>71</sup>Some cities may be created for reasons as simple as avoiding annexation by a larger city or merely to enforce strict zoning laws within a small area.

- The county must approve the incorporation and the new city must have a property tax that produces revenues at least equal to the amount of annual state-shared taxes received.
- The territory to be incorporated must be a specified distance from the nearest existing city.
- A newly incorporated city is required to adopt a plan of services by ordinance within 6 months after the incorporation election.

This legislation detailed the requirements for the development of countywide growth plans covering a 20-year planning horizon. This legislation also called for the establishment of countywide Joint Economic and Community Development Boards (JECDBs) intended to foster ongoing communication and cooperation between county and city governments. This landmark statute established a new set of requirements for city annexations and incorporations in Tennessee, as well as for the consolidation of local governments.

As envisioned by the General Assembly, these growth plans were intended to:

- eliminate annexation out of fear;<sup>72</sup>
- establish incentives to annex or incorporate when appropriate;
- more closely match the timing of development and the provision of public services;
- stabilize each county's education funding base; and,
- establish an incentive for each county legislative body to be more interested in educative matters and minimize urban sprawl (TCA 6-58-102).

PC 1101 provides for Tennessee's counties and their city governments to develop countywide growth plans. These plans are to establish Urban Growth Boundaries (UGBs) for cities, as well as Planned Growth Areas (PGAs) and Rural Areas (RAs) for

---

<sup>72</sup>To prevent another city from annexing an area first.

counties, and are intended to guide the future growth and development within each county over the next 20 years. Once approved, all land use decisions made by the city or county legislative bodies or planning commissions are required to be consistent with the approved growth plan. Once approved, these growth plans were to remain in effect for a minimum of three years before being eligible for amendment.

A newly incorporated city is required to adopt a plan of services by ordinance within 6 months from the incorporation election. The plan of services shall include, but not be limited to:

- police protection,
- fire protection,
- water service,
- sanitary sewage system,
- solid waste disposal,
- road and street construction and repair,
- recreational facilities,
- a proposed five-year operational budget, including projected revenues and expenditures, and the revenue from purely local sources to be payable annually.

While seven services must be included in the plan of services, it is not mandatory that a city itself deliver the service. Many cities obtain basic services from their county government, or special utility districts, such as water, sewer, and fire districts.

Cities incorporated after May 19, 1998<sup>73</sup> that produce no local own-source revenues in any fiscal year are prohibited from receiving any state-shared revenues during the next fiscal year. Table 12 shows the current requirements for incorporation.

It is interesting to note that Tennessee currently has 162 cities that fall below the minimum 1,500 population threshold for incorporation. Almost half (46%) of the state's existing cities and

---

<sup>73</sup>TCA 6-58-112.

**Table 12. Tennessee Incorporation Standards (July 2003)**

Form of Charter	Population Minimum	Distance From Other City	Plan of Services	County Approval	Limited to Planned Growth Area	Property Tax Required	Other
Home Rule(1)	Can only be adopted by existing municipalities						
Manager-Commission(2)	1,500	5 miles from cities of 100,000 or more; three miles from other cities	Yes	Yes	Yes	Yes	Referendum
Mayor-Aldermanic(3)	1,500	5 miles from cities of 100,000 or more; three miles from other cities	Yes	Yes	Yes	Yes	Referendum
Modified Mgr.-Council(4)	5,000	5 miles from cities of 100,000 or more; three miles from other cities	Yes	Yes	Yes	Yes	Referendum: available to new cities only
Metropolitan Government (5)							In recent years, two new metro govts. have been formed. Eight others
Private Act	Prohibited by constitutional amendment adopted in 1953						

Notes: (1)Tennessee Constitution, Article XI, Section 9. (2) TCA 6-18-103. (3) TCA 6-1-201. (4) TCA 6-30-103. (5) TCA 7-1-101.

towns could not qualify if they were attempting to become cities today. It will be interesting in coming years to see what effect the more stringent standards for incorporation will have on the services provided by counties and special districts and on city annexation. It is clear that current public policy in Tennessee discourages frivolous new incorporations.

### **CITY SERVICES**

In the preceding section, the reasons for incorporating as a city were discussed. A city can capture local tax revenues and qualify for state tax sharing. These two factors, for better or worse, have undoubtedly been important considerations in many incorporations over the past half-century. The desire to control growth and maintain the character of the community through zoning has also been a significant motivation in some high income suburban areas.

Among all the motivations for incorporation, the most justifiable is to provide a higher level of services. Counties, supplemented by special districts, provide what may be referred to as the “default level” of local government services. “Default” services are those a citizen can get without having to become a city. More than anything else, cities should be about services. It is the physical and service infrastructure of cities (water, sewer, drainage, police and fire protection, airports, etc.) that make economic development possible, and development benefits not only those living in the city, but all county residents.

County governments usually have too large a land area to provide intensive urban-type services to all their citizens. On the other hand, many cities are too small to provide much in the way of services. Of Tennessee’s 348 cities, 129 (37%) have a total land area of less than two square miles.<sup>74</sup> Land area, population size and density, and revenues available from their own sources and from state-shared taxes, all affect the number and level of services that cities are able to provide.

---

<sup>74</sup>Municipal Technical Advisory Service, *Directory of Tennessee Municipal Officials*, University of Tennessee, Knoxville. September 2002.



Residents of any territory attempting to incorporate must propose a specified plan of services which is to include, but not be limited to: police protection, fire protection, water, sanitary sewers, solid waste disposal, street and road construction and repair, and parks and recreation facilities. These are the services that are considered essential to “city-hood.” A city can show its commitment to its corporate responsibilities by providing additional services such as planning, zoning, code enforcement, and a library, but the seven cited are the basic ones. The statute merely requires prospective cities to address the provision of these services and prescribes no standards. However, implicit in the requirement is that these services should be provided to citizens as a bare minimum.

The term “full service” has been applied to cities that are providing all these essential services, but that designation bears further analysis. First, any evaluation must take into account the adequacy and effectiveness of the service. A city fire department staffed by career professional firefighters must be granted a higher standing than one with all volunteers. A city with a full time parks and recreation department should be rated above one that assigns those tasks to city employees with other responsibilities. A city with a police chief and two officers is trying harder to provide service than one that contracts with the county sheriff for law enforcement. Any definition of “full service” should have a qualitative dimension that looks to the level or quality of service that is being provided.

The second consideration pertains to how the service is provided, and here there are at least two schools of thought. One school looks to service delivery without regard to the provider. The basis of this approach is that services are whatever citizens demand and are willing to pay for, regardless of how they get the service. There is merit to the position that as long as citizens are satisfied with the service and level of service they are receiving, it doesn’t matter who is providing them. Flexibility is good because cities are diverse, and citizens differ in what they expect and what they can afford. If city residents get adequate water service from a utility district, that is a reasonable choice. If a metropolitan county can collect and treat sewage better and more efficiently than a suburban city, that is a better choice. After all, some economic principles apply to services. There must be a “critical mass” of residents before certain services, particularly those involving capital intensive infrastructure,

are feasible. Some services, such as water and sewer, are conducive to economies of scale. Other desirable values such as non-duplication of services and intergovernmental cooperation are factors to be considered.

It is possible for a Tennessee city to rely on the county sheriff for law enforcement, get fire service from a non-profit volunteer department, water from a utility district, sewer service from an adjoining city, trash pickup by individual arrangement with private haulers, street maintenance from a private contractor, and provide no parks and recreation service. Under this scenario a city may not provide any services directly, but citizens could be satisfied with this smorgasbord of service delivery arrangements. Unicoi, one of the largest cities without a police department, depends upon the county sheriff to respond to calls. Lakeland receives fire service from the all-career Shelby County Fire Department which is building a station in the middle of the city. Farragut residents get their water from a utility district. Hendersonville has its sewage collected by a utility district and treated by Metro Nashville. Brentwood residents make their own garbage pickup arrangements with private haulers, a practice that was in place when the city was incorporated. Forest Hills has only one full-time employee and bids out street work to private contractors. Red Bank has no parks and recreation department, but it is located between a state forest and Chickamauga Lake, and residents have easy access to the facilities of Hamilton County and Chattanooga. Proponents of the flexible, pragmatic approach to services see no problem with these arrangements.

However, there is another school of thought that believes that a city should be providing, or arranging for, a service before the term “full service” should apply. This school points out that in the flexible scenario outlined above, citizens in each case are receiving only “default” services—the same ones they would be receiving if there were no city. This approach has four premises: (1) the city should provide the service; (2) the city should own the service; (3) the city should control the service; and (4) the city should have financial responsibility for the service. All premises do not necessarily apply to each service. For instance, it is perfectly satisfactory for a city to contract with a private company for garbage pickup because the city is arranging for the service, it controls the service through the contract, and it has financial responsibility for

the service. A city that has a joint arrangement with the county for parks and recreation services still qualifies as a full service city because it is co-providing the service, has a voice in how services are provided, and because the arrangement is voluntary and can be terminated for cause.

### ***CITY DATA SOURCES***

No one-stop data warehouse on city government finance (detailed revenue, expenditure, and employment data) exists in Tennessee. The last detailed statistical report on Tennessee city finances produced by a Tennessee government agency was completed in 1997 and covered fiscal year 1995.<sup>75</sup> The absence of a complete and reliable data source for current city government activity makes it exceedingly difficult to evaluate the operations of city governments in Tennessee on any kind of ongoing basis. Therefore the descriptions of city services detailed in this section are based on information obtained from a variety of sources. Some detailed current statistical data on the major categories of city services was obtained from communications with various individual service sector sources. The data source for each of the detailed services for which current data was obtained is noted at the beginning of the discussion for each service.

Less current but detailed fiscal and employment data was obtained for most but not all cities from the 1997 Census of Governments. Detailed data on city finances and employment (as well as those of counties, towns, special districts, and school districts) is collected and produced at 5-year intervals by the U. S. Census Bureau.<sup>76</sup> While the most recent Census of Governments was completed in 2002, detailed fiscal data (in publication form) from that survey will not be released until 2004.<sup>77</sup> Therefore the fiscal data from the 1997 Census of Governments (COG 97) is used to complement the more current city service information that is the basis for the following sections. For some services, only the COG 97 data is

---

<sup>75</sup>See Comptroller of the Treasury (1997). That report did not provide sufficient detail with which to analyze the various types of city services provided to citizens (other than data for road and highways and education).

<sup>76</sup>The Census of Governments has been conducted every five years since 1957. The survey gathers information in three main areas: government organization, employment, and finances.

<sup>77</sup>Public use datasets may not be available until 2005.

available. A more detailed description of the scope and limitations of the *Census of Governments* survey and procedures is included in the Appendix.

**DETAILED DISCUSSION OF CITY SERVICES**

Following is a discussion of the seven essential city services that are identified in PC 1101.

**POLICE SERVICES**

**Table 13. Summary of City Police Service**

196	56%	City departments with coverage 24 hours per day, 7 days per week
66	19%	City departments, but not enough officers to provide 24/7 coverage
15	4%	Cities without departments that contract with the county sheriff
71	21%	Cities without departments that rely on the sheriff without a contract
348	100%	

Source: Municipal Technical Advisory Service, *Police Department Survey 2000*, University of Tennessee, Knoxville. 2000.

According to the Municipal Technical Advisory Service, it requires the equivalent of 5 full time officers to provide 24 hour, 7 days per week coverage.<sup>78</sup> A city was categorized as having a full service police department if the number of its full time and part time officers totaled 5. Table 13 shows that there are 262 city police departments in Tennessee, and three-fourths of these are considered full service. One-fourth of Tennessee cities do not have police departments, and about 90% of these are below 2,500 population. Those not having a department are shown here in two categories because the 15 that have a contract or agreement with the county sheriff demonstrate a higher level of responsibility and expenditure than just expecting the sheriff to respond to calls without any agreement or additional compensation. These contracts vary from place to place. Some arrangements are formal and specify the number of hours to be worked and tasks performed. In other cases, the city may just agree to provide funding for one or two additional deputy positions, with the understanding that those persons will be assigned to their city.

<sup>78</sup>Rex Barton, Police Management Consultant, Municipal Technical Advisory Service, University of Tennessee, Knoxville.

The only cities over 5,000 population that do not have a department are Farragut (17,720) that contracts with the Knox County sheriff, and Lakeland (6,862) that relies on the Shelby County sheriff without a contract. Neither city has a property tax.

There are many variables that affect the need for law enforcement. Population, location, demographic makeup, traffic, and the sale of alcohol are all relevant factors. City police departments enforce city ordinances, but they also enforce state law—a duty that would fall to the county sheriff if the city had no department.<sup>79</sup> This dual enforcement raises an important point. A city that has no department and merely relies on the sheriff can have state law enforced within its boundaries, but without a specific agreement the sheriff has no authority to enforce city ordinances. Cities that just rely on the sheriff are not enforcing their own ordinances within their corporate limits.

Law enforcement offers the most limited options of any service. In 99.9% of cases, citizens of Tennessee receive law enforcement service exclusively from either a city police department or the county sheriff. There are three possible exceptions. First, the office of constable still exists in a few counties (Anderson, Macon, Roane, and Williamson for example). Constables are elected from districts established by the county legislative body, and some of these may include a city or a portion of a city. Some constables still have law enforcement powers—usually involving traffic control. They are not on the county payroll, and are compensated by an arrest fee for every arrest they make. In other counties, constables have been stripped of enforcement powers and their only responsibility is to serve civil process papers, for which they receive a fee. There is not much central information available on constables because the office has been abolished in the great majority of counties.<sup>80</sup>

Second, there are still some city charters that provide for a marshal (see the Charter of the Town of Saltillo). While such references have been deleted from most charters as they are updated, the office is synonymous with the position of police chief. If there still

---

<sup>79</sup>Dennis Huffer, Legal Consultant, Municipal Technical Advisory Service, University of Tennessee (Nashville).

<sup>80</sup>Ron Fults, Chief Legal Consultant, County Technical Assistance Service, University of Tennessee (Nashville).

are any city marshals, they would function as the head of the police department.

The third caveat is that at least one city that does not have a police department but has contracted with a private security company to patrol the streets as a supplement to their other law enforcement arrangements. However, the persons on patrol are not sworn officers and do not have legal authority to make arrests.

**FIRE SERVICES**

**Table 14. Summary of City Fire Services**

41	12.0%	City departments with all career firefighters
24	7.0%	City departments with predominantly career but some volunteer firefighters
58	17.0%	City departments with predominantly volunteer but some career firefighters
166	48.0%	City departments with all volunteer firefighters
7	0.5%	City departments with all part-time firefighters
7	0.5%	No city department, service by another entity with all career firefighters
1	0.5%	No city department, service by another entity with predominantly career firefighters
16	5.0%	No city department, service by another entity with predominantly volunteer firefighters
23	7.0%	No city department, service by another entity with all volunteer firefighters
2	1.0%	No city department, service by another entity with all part-time firefighters
2	1.0%	Joint service with another entity, predominantly volunteer firefighters
1	0.5%	Joint service with another entity, all volunteer firefighters
<b>348</b>	<b>100.0%</b>	

Source: State Fire Marshal, Tennessee Department of Commerce and Insurance, *Tennessee Fire Department Data*, Nashville, 2003, and *Tennessee Fire Service Directory*, Nashville, 2002; National Fire Protection Association, *Fire Protection Handbook*, Quincy, Mass., 1991, and *U.S. Fire Department Profile Through 2001*, Quincy, Mass., 2002. Special thanks to Dennis Mulder, Coordinator, Tennessee Fire Incident Reporting System, Office of the State Fire Marshal.



Fire protection is the most varied of all the city services, and the most difficult to evaluate and categorize. Table 14 shows that 296 cities (85%) have fire departments and three others have joint service with another entity. There are 49 cities that do not have a fire department. Their citizens are served by other entities such as a county, another city, a private fire company, a special fire district, or a volunteer department. There are a total of 654 fire departments in Tennessee and city departments make up 46% of this number.<sup>81</sup>

Of Tennessee's 95 counties, 29 have countywide fire departments that serve mostly unincorporated areas. However, even where that is the case, as in Shelby and Wilson Counties, there are cities that contract with them for fire service. Three counties, Fentress, Haywood, and Pickett, have joint city-county departments that provide coverage to cities as well as unincorporated portions of the county. Departments in Carroll, Cocke, Cumberland, Hardin, Henderson, McNairy, and Meigs counties all indicate that they are providing fire protection to portions of cities.<sup>82</sup>

There are only 4 cities over 5,000 population that do not have their own fire departments. Farragut, the largest (17,720), has granted a franchise to a private fire department which then markets subscriptions to individual homeowners and businesses. Mount Juliet (13,997) contracts with Wilson County; Lakeland (6,862) contracts with the Shelby County department; and Collegedale (6,514), is served by a non-profit fire department. Many of the city departments that are all, or predominantly, volunteer are organized as non-profit organizations rather than departments of city government and usually serve a much wider area than just the city. Non-profit departments may offer subscriptions to customers and most of those that do, serve everyone. If you are a subscriber, there is no charge for responses. If you are not a subscriber, the fee is usually \$1,500 or more per call, and this constitutes a legal obligation that is enforceable on the recipient.<sup>83</sup>

---

<sup>81</sup>Ray Crouch, Fire Department Management Consultant, Municipal Technical Advisory Service, University of Tennessee (Nashville).

<sup>82</sup>Kevin Lauer, Fire Management Consultant, County Technical Advisory Service, University of Tennessee (Nashville).

<sup>83</sup>Ray Crouch, MTAS.



One city, LaVergne, contracts with a private fire company to serve its residents and businesses. Pleasant View has a fire department that is organized as a utility district.<sup>84</sup> Many large industrial complexes and airports have their own fire departments that supplement any services provided by local entities. A number of cities have intergovernmental agreements with counties and other cities for responses to fires and other emergencies, and some are now offering subscription services to homeowners and businesses that lie outside their corporate boundaries.

In the 2003 session, the General Assembly passed Public Chapter 312, codified at TCA 68-102-301, known as the Fire Department Recognition Act. The purposes of this legislation are to: establish standards, qualifications, and classifications for fire departments; secure the approval of the state fire marshal and all local governing bodies in the service area as a prerequisite to operation; require registration and renewal every three years for all fire departments; and to limit the solicitation of funds to recognized departments. As a result of this legislation, the state now has a comprehensive list of fire departments and the areas they serve.

As Table 14 shows, there is a variety of combinations of career, volunteer, and part-time firefighters in city fire departments, and this bears some discussion. The largest cities tend to have “all career” full-time firefighters. Other large cities (Bartlett, Millington, and Maryville) are categorized as “predominantly career” because they report having a surprising number of “volunteers.” Maryville, for instance, has 39 career professional firefighters and 25 volunteers, but these are not the same as volunteers in small towns. Maryville actively recruits persons for volunteer positions. Once selected, volunteers undergo rigorous training—mostly on weekends. Each person must commit to be on duty a certain number of hours per week for which they are scheduled and paid. These volunteers get a guaranteed second income, and the department gets trained, committed people who can substitute for career firefighters when they are sick or on vacation. Volunteers are trained to perform all the tasks of a career firefighter except that they do not drive fire vehicles.<sup>85</sup> These volunteer positions are highly sought-after, and Maryville has more applicants than it

---

<sup>84</sup>Ibid.

<sup>85</sup>Ed Mitchell, Fire Chief, Maryville, Tennessee.

can afford to hire. These “volunteers” are actually part-time firefighters and that is how they are listed in many other cities. Part-timers have regular assignments for which they are compensated. A true volunteer is someone who becomes a firefighter on call. Volunteers may be unpaid, may be paid for each response, or may receive alternate compensation such as paid insurance.<sup>86</sup> Many of the smaller cities with all, or predominantly, volunteer departments have a full-time career professional as the fire chief.

Fire protection is the only city service that is graded or evaluated by an external agency. The Insurance Services Office (ISO) serves the property insurance industry by evaluating exposure to risk. Fire departments are scored on a “1” to “10” scale on such factors as water supply, firefighter training, number of stations, and adequacy of equipment. On the ISO scale, “1” is the highest score and “10” denotes no protection at all. One city in Tennessee, Memphis, has a “2” rating, while most of the other large cities are rated “3”. A good fire department with paid firefighters should be at the “4” or “5” level. A rating of “7” would be very good for an all volunteer department. Most are rated “9” which is minimal coverage, but a department with water trucks and access to lakes and ponds might garner an “8.”<sup>87</sup> The ISO system provides an incentive for cities to improve their fire service so that businesses and homeowners can benefit from lower fire insurance premiums. Every insurance company operating in Tennessee uses the ISO system except for State Farm (25% of the market), which has gone to an experience rated system based upon ZIP codes.

---

<sup>86</sup>Stuart Crine, Director, Tennessee Fire Training Academy, Shelbyville, Tennessee.

<sup>87</sup>Ibid.

**WATER SERVICES****Table 15. Summary of City Water Services**

205	59%	City departments that own the treatment plant and distribution system
19	5%	City departments that own the distribution system, but not the treatment plant
124	36%	City is served by another entity that owns the treatment plant and distribution system
0	0%	Cities with no service whose residents rely on wells
<b>348</b>	<b>100%</b>	

Source: Municipal Technical Advisory Service, University of Tennessee, *Municipal Utility Rate Survey 2000*, Knoxville, July 2001; and Division of Water Supply, Tennessee Department of Environment and Conservation, *State of Tennessee Public Water Systems*, Nashville, July 2003.

Only 205 cities own and operate their water treatment and distribution systems. There are many variations in the provision of water. Chattanooga is served by a privately owned water company. There are over 150 water utility districts in Tennessee. They represent the single largest category of special districts in the state. These serve rural areas primarily, but they also provide water to almost one-third of the state's cities. Some smaller cities, even those that have a water department, do not operate the treatment plant or the distribution system. They are served by another city (especially in metropolitan areas) or by a utility district that treats the water and distributes it to customers. Other cities do own and operate the distribution system but purchase treated water from another entity. Many cities have extended their water lines beyond their boundaries in anticipation of population growth and annexation. Usually, these outside customers are charged higher rates than city residents pay.

Utility services (water, sewer, electricity, and gas) are different from other services in several ways. First, they are often organized as a separate "company" within city government. These enterprises are commonly managed by a utility board or commission whose members are appointed by the mayor and confirmed by the governing body which functions as a quasi-independent entity. Second, TCA 7-34-115(a) requires city utility systems to operate on a self-sufficient basis. User charges, rates, and fees must reflect the actual cost of providing the service, and no public utility can

operate for profit or as a source of revenue for a governmental entity. A city that operates a utility is entitled to an annual return of 6% on its equity investment and to a payment in lieu of property tax if requested by the governing body. Although most utilities derive all their operating funds from user charges and fees, cities are authorized to subsidize the system from general fund revenues through budgeted appropriations. TCA 7-35-414 requires that depreciation be built into the rate structure so that physical plant and infrastructure replacements are funded in advance.

All water systems in Tennessee are permitted and regulated by the Division of Water Supply in the state Department of Environment and Conservation. Utilities that experience an operating or retained earnings deficit, or that have defaulted on a debt instrument, are subject to oversight by the state Water and Wastewater Financing Board (TCA 68-221-1010).

**SEWER SERVICES**

**Table 16. Summary of City Sewer Services**

206	59%	City departments that own the collection and treatment systems
31	9%	City department owns the collection system, but not the treatment plant
33	10%	City is served by another entity that owns the collection and treatment systems
78	22%	No sewer service, city residents rely on septic tanks
348	100%	

Source: Municipal Technical Advisory Service, University of Tennessee, *Municipal Utility Rate Survey 2000*, Knoxville, July 2001 previously cited, and Division of Water Pollution Control, Tennessee Department of Environment and Conservation, *Municipal Sewer Services*, Nashville, July 2003.

As Table 16 indicates, 78% of Tennessee’s cities have sewer service, but all are not operating the collection and treatment systems. In the Nashville area, all suburban cities in Davidson County and several systems in Sumner, Williamson, and Wilson counties are connected to an area-wide treatment system operated by Metro. Many cities, including those that own the entire system, contract with private companies for operation and maintenance. Unlike water service, which is now universal, almost one-fourth of Tennessee cities have no sewer service except for septic tanks.

There are several possible reasons for this. All of the non-sewered cities are small and lack the critical mass of population that would make sewers economically feasible. Most are in rural areas where there is not an adjacent city, nor even a utility district, to provide service, and some are in areas of the state where ground rock makes digging sewer lines prohibitively expensive.

Sewerage is one of the most important city services and there are some cities that do not fit readily into any of the categories in Table 16. A few cities use land disposal systems. Others operate what is known as a grinder pump system in which tanks and pumps are installed at service locations. In some cases the city owns and maintains the pumps; in others the customers own the pumps.

Whereas water charges are based upon the metered usage of each customer, sewer charges are not. Very few sewer lines have metering because, unlike water pipes, sewer lines are not under pressure. In the vast majority of cities, the monthly sewer charge is a fixed percentage of the water bill, and both services are billed together. A number of cities have combined water/sewer departments. City sewage utilities are covered by the same statutes that apply to water systems. Every system in the state that discharges treated waste into a river, stream, or reservoir is required to have a National Pollution Discharge Elimination System (NPDES) permit from the Division of Water Pollution Control of the state Department of Environment and Conservation. Cities that have a collection system, but whose waste is treated by another entity must have a State Operating Permit. This also applies to the few cities where treated wastewater is applied to the land, rather than being discharged into a river or stream.<sup>88</sup> Cities whose sewage is collected and treated by another entity are not required to have a federal or state permit.

---

<sup>88</sup>Roger Lemasters, Chief Engineer, Division of Water Pollution Control, Department of Environment and Conservation, Nashville.

## **SOLID WASTE SERVICES**

**Table 17. Summary of City Solid Waste Services**

135	39%	City provides service using city crews
87	25%	City provides service using a private contractor
12	3%	City provides service, but details are not known
114	33%	No solid waste service provided by city
348	100%	

Source: Municipal Technical Advisory Service, University of Tennessee, *Municipal Utility Rate Survey 2000*, Knoxville, July 2001

There are 234 cities providing, or arranging for, solid waste pickup for their citizens. This amounts to 67% of all Tennessee cities.

In cities without any service, residents have to make their own pickup arrangements with private haulers or take their trash to the nearest county convenience center. In these situations, houses in a single block may be served by several different haulers, and there is often dissatisfaction with the quality and cost of the service. Solid waste collection is not regulated by the state, and some cities that don't provide service are not licensing and regulating the private contractors that operate in their city.

Solid waste collection and disposal is the most regional service provided in Tennessee. There are 56 single-county solid waste planning regions; one 2-county region; five 3-county regions; three 4-county regions; and one 10-county region. Thus, all 95 counties are involved in solid waste planning and management. The primary focus of these regional entities is landfill disposal, but every county provides at least limited collection in the form of "convenience centers." Counties are required to provide and maintain one convenience center for each 180 square miles of territory, or 12,000 citizens. They are also subject to other requirements for volume reduction, recycling, and household hazardous waste collection that do not apply to cities. Because county solid waste services are funded through the property tax, city residents can use the convenience centers.

Of 216 cities that responded to a recent rate survey, 81 fund garbage service through a separate fee; 56 finance it through the general fund; and 79 use a combination of fees and general revenues. In most of the latter cases, the city charges businesses



and homeowners a flat monthly fee and supplements the remaining cost of the service from the general fund. Some 82 cities, mostly in middle and east Tennessee, have recycling programs. While the state does not regulate solid waste collection, it does regulate landfills. It is estimated that in the early 1990s, there were as many as 100 solid waste disposal sites across the state. That is now down to 35 licensed operating landfills.<sup>89</sup>

## STREETS

Street construction and maintenance is the only city service that is subsidized directly by the state on an entitlement basis. In fiscal year 2003-04, each of Tennessee's 348 cities will receive \$27.13 per capita from state gasoline and motor fuel taxes.<sup>90</sup> The General Assembly, in spite of a budget crisis, made no reduction in this state-shared tax for the current fiscal year. Amounts paid, by population, are shown below for illustration:

These funds must be spent on streets. Over time, there has evolved lists of permissible and prohibited expenditures. For instance, lighting, mowing of the right-of-way, purchases of maintenance vehicles, and employee salaries and benefits are expenses that may be paid from state street aid funds. The costs of employee bonuses, city "welcome" signs, and non-street related drainage improvements may not be paid from those funds.<sup>91</sup> Many small cities (under 1,000 population) list the position of "street superintendent" in the Directory of Municipal Officials. This

**Table 18. Amounts Paid by Population for Street Construction and Maintenance**

City Population	State Street Aid Amount
1,000	\$ 27,130
2,500	67,825
5,000	135,650
10,000	271,300
20,000	542,600
40,000	1,085,200

Source: Municipal Technical Advisory Service, *2003-2004 State Revenue Estimates*, University of Tennessee, Knoxville, June 4, 2003. Calculations by TACIR. Based on \$27.13 per capita for FY 2004.

<sup>89</sup>Louis Bordenave, Division of Community Assistance, Department of Environment and Conservation, Nashville.

<sup>90</sup>Municipal Technical Advisory Service, "2003-2004 State Revenue Estimates", University of Tennessee, Knoxville, June 4, 2003.

<sup>91</sup>Municipal Technical Advisory Service, "State Street Aid Fund Expenditures", University of Tennessee, Knoxville, January 2003.



employee is compensated, at least in part, from state street aid funds, and his primary, or sole, responsibility is to supervise the expenditure of that money. The vast majority of small cities bid out their street construction and maintenance projects to private contractors, but a few contract with the county for that work. County road departments are prohibited by law from performing city street work without compensation. Under TCA 54-7-202(2), the county governing body may authorize the road department to perform work for other governmental entities, provided that the cost of that work is reimbursed. Without state street aid money, many small cities would not be able to pay a street superintendent and some might be unable to maintain their streets adequately.

**PARKS AND RECREATION**

**Table 19. Summary of Parks and Recreation Services**

100	29%	City departments
3	1%	City has a joint department with another city and/or county
24	7%	City provides some level of service, but has no department
32	9%	City provides no parks and recreation service
30	54%	No information
189	100%	

Source: Department of Health, Physical Education, Recreation, and Safety, Middle Tennessee State University, *2003 Tennessee Municipal and County Recreation and Park Agencies*, Murfreesboro, 2003.

One hundred three (103) cities provide a full service level of parks and recreation services. These cities all have a department headed by a full time director. Brownsville and Haywood County have a combined operation, as do Alcoa, Maryville, and Blount County. Adamsville (1,983) is the smallest city having a full department. It is highly unlikely that any cities below that population have full time departments, although seven cities below 1,000 population list the position of “parks and recreation director” in the Directory of Municipal Officials. In one of those cases, the director is also the city recorder, and in another, an alderman. In these very small places, the director is an unpaid volunteer whose only responsibility may be scheduling the community center or a ball field.

Tennessee has no park or recreation districts, so all services are provided by counties, cities, and private or non-profit organizations. Whether a city has a parks and recreation department seems to be strongly correlated with population size. Overall, across the state, there are at least 127 cities that provide some level of services. Of those over 10,000 population, 46 of 48 have a full time department; Red Bank and Soddy-Daisy being the only cities that do not. Of those 39 cities between 5,000 and 9,999 only Collegedale, Henderson, Lynchburg, Millersville, and Spring Hill have no department. All of the cities for which there is no information are below 2,500 population.

It appears that location is also a key factor in determining what park and recreation services, if any, a city provides. Dunlap has no department because a large county park is only three miles away. Satellite cities in Davidson County, except for Goodlettsville, have no departments because Metro Nashville has extensive parks, golf courses, and other recreation facilities. Proximity to national forests, state parks, and TVA or Corps of Engineers lakes can also reduce the need for city park and recreation services.

Of all the city services, parks and recreation involves the most interactions with other entities and organizations. Some cities own and operate all facilities and concessions themselves. Others contract out the operation of specialized facilities such as golf courses. Most have interagency agreements or contracts with civic clubs, youth baseball leagues, and similar organizations for the operation of recreation buildings, playing fields, tennis and basketball courts, skating rinks, swimming pools, and other facilities. In many cases, a league or club has deeded a field or facility to a city for insurance and maintenance purposes. It is common for a city to own, operate, and maintain a baseball field but have a civic club sponsor teams, pay for uniforms and equipment, and provide volunteers for concessions and other tasks. The Lions, Optimists, and Kiwanis Clubs, American Legion, Boys and Girls Clubs, Babe Ruth League, Little League, and churches are traditional partners with cities for youth recreation. Another traditional partner in many places is the local school system. Cities sometimes use school facilities for summer recreation programs, or they may contract for use of city recreation facilities by the school system. Many schools contract with cities for recreation services for their after-school programs.

Parks and Recreation has the most varied sources of funding of any city service. Operating revenues may come from general fund appropriations; fees, charges, and admissions; concessions; individual and organizational donations and sponsorships; contracts with other agencies for use of facilities, services, and personnel; state and federal grants; and special taxes.<sup>92</sup> Many cities with departments are located in counties that have no parks and provide no recreation services. In such cases, it is common for the county commission to appropriate a modest sum to a city so county residents can use the city parks and services, although charging non-resident fees for the use of city facilities is not common in Tennessee. A few cities have earmarked a portion of their property tax for parks and recreation purposes. This is usually done for capital projects.

Parks and Recreation is the most seasonal of the services provided by cities. Many cities that do not have full time, year-round departments hire extensively for summer programs. This is one reason why it is so difficult to evaluate the level of services that a city is providing. One of the surprising facts turned up by this research is the large number of cities, often quite small, that are providing some service in the area of recreation.

### ***OTHER CITY SERVICES***

The seven services discussed are included because they are cited in the plan of services required for new incorporations. That statute reads, however, that the plan of services is “to include, but not be limited to” those listed. In fact, many of the state’s 348 cities do provide a variety of other services. For instance, there are 62 city electric distribution systems.<sup>93</sup> Many of these serve multiple suburban and outlying cities as well as some unincorporated areas. Most smaller cities and rural areas are served by one of Tennessee’s 23 electric cooperatives. All cities are provided electricity by a Tennessee Valley Authority distributor, except for Kingsport, which is served by a private electric power company.

---

<sup>92</sup>Candi Rawlins, Executive Director, Tennessee Recreation and Parks Association, Nashville.

<sup>93</sup>Frances Adams-O’Brien, Information Resources Manager, Municipal Technical Advisory Service, University of Tennessee, Knoxville.

Approximately 60 cities own and operate gas systems.<sup>94</sup> The others, where natural gas is available, are served by private transmission companies. Zoning has been adopted in most of the 87 cities over 5,000 population. About one-third of the 260 cities under 5,000 have zoning. Other services listed in the Directory of Municipal Officials include: planning, codes enforcement, libraries, public works, emergency management, and economic and community development. Also, 27 cities operate school systems: Alamo, Alcoa, Athens, Bells, Bristol, Cleveland, Clinton, Dayton, Dyersburg, Elizabethton, Etowah, Fayetteville, Greeneville, Humboldt, Johnson City, Kingsport, Lenoir City, Lexington, Manchester, Maryville, Murfreesboro, Newport, Oak Ridge, Rogersville, Sweetwater, Tullahoma, and Union City. Memphis has been excluded from this list because the Attorney General's Office has found that the Memphis school system is actually a special school district.

Based on appropriate adjustments, the COG 97 data indicates that education spending by cities is \$453 million.<sup>95</sup>

### ***STATE ROLE IN CITY SERVICES***

This report would be incomplete if it failed to note the many ways that the State of Tennessee is involved in the provision of city services. That role goes far beyond state tax sharing. In the area of police, for instance, the state has established standards for officers through the Peace Officers Standards and Training Commission. The state operates a training academy for police officers, and funds salary supplements for officers who complete in-service training. The Tennessee Bureau of Investigation operates a crime laboratory that assists local police agencies in crime investigations.

The state has similar involvement in city fire services. Standards are established by the Commission on Firefighting Personnel Standards and Education. The state fire training academy near Shelbyville is a new facility where local firefighters receive state-of-the-art training. The General Assembly also funds salary supplements for firefighters who complete in-service training. The

---

<sup>94</sup>Ibid.

<sup>95</sup>Education spending by special school districts is \$649 million, largely due to Memphis' adjustment.

state has recently established standards for fire departments, and maintains a registry of approved departments. All fire departments are required annually to report the volume of calls and the number of actual fires to the fire marshal's office. The state fire marshal is required to review and approve all plans for schools and other buildings where large numbers of people will be assembled. That office also assists local departments in arson investigations and administers the certification program for fire inspectors and codes enforcement officials. Unlike most neighboring states, however, Tennessee provides no grants or loans to improve local fire service, no free auto tags for volunteer firefighters, and no state death benefit for firefighters killed in the line of duty.

The state is deeply involved in city utilities and especially water and sewer services. All local departments must have federal and state operating permits from the Department of Environment and Conservation. The state tests drinking water and provides technical assistance to local water departments. The state Water and Wastewater Financing Board regulates the financial management of city utilities and the uses of utility revenues. Storm water runoff is regulated by the state, and the state imposes fines and penalties on cities that experience fish kills and other environmental incidents. Water and wastewater plant operators are required to be trained and certified, and there is a state board that regulates that process.

Tennessee does not regulate solid waste collection, but the Department of Environment and Conservation does license and regulate landfill disposal. State statutes require counties and cities to have solid waste plans, and counties are required to provide convenience centers for the disposal of household trash. The state also regulates hazardous wastes, recycling, and waste reduction.

The Department of Transportation provides bridge grants and assistance with mass transit, airports, rail lines, and barge traffic. There are state statutory provisions governing utility relocation for street, road, and highway construction.

There are state statutes dealing with park planning and city recreation systems. Perhaps the largest state role in this area is the Parks and Recreation Technical Advisory Service (PARTAS) in the Department of Environment and Conservation. This agency provides technical assistance to local governments and administers

a grant program. The state also plays a significant role in other city services such as planning, emergency management, and economic development. Perhaps most importantly, the General Assembly funds a large portion of the budgets of the Municipal Technical Advisory Service (MTAS) and the County Technical Assistance Service (CTAS) of the University of Tennessee's Institute for Public Service. These agencies work with cities and counties on a daily basis to improve their operations and enhance the services they provide. Specialized consultants are on staff in the areas of law, engineering, police, fire, public works, utilities, finance, human resources, and general management. Without this special assistance, the level of city and county services would be much lower and less efficient.

**CITY SERVICES: SUMMARY AND FINDINGS**

The detailed data show that city services vary extensively from city to city. At a minimum, all cities provide some level of street and highway services, given that all cities receive some state-shared motor fuel taxes that must be used for streets and roads. Cities may produce these services themselves or contract them out to private businesses or some combination.

Table 20 presents a summary description of city services provided based on data from the 1997 Census of Governments. This table does not distinguish between a city that provides a minimal level of a service versus a relatively high level of service (this question is addressed in Table 21). Table 20 is based on seven major services or functions that cities are expected to provide to their residents:<sup>96</sup> (1) police, (2) fire protection, (3) streets and highways, (4) parks and recreation, (5) solid waste, (6) water and (7) sewer. The

**Table 20. Summary of City Services Provided**

# of Services Provided	# of Cities Providing Services (Based on COG97)
1	17
2	23
3	37
4	28
5	44
6	73
7	122
<b>Total</b>	<b>344</b>

Note: Services include: police, fire, streets and highways, parks and recreation, solid waste, water, and sewer.  
 Source: 1997 Census of Governments.

<sup>96</sup>There is no universally-accepted definition of full-service city. However, most definitions include the services in the definition given above.



data shows that there are only 122 Tennessee cities out of a total of 344 that provide some level of all 7 services.

**Table 21. Summary of City Services Provided**  
(More Stringent Criteria)

# of Services Provided	# of Cities Providing Services (Based on COG 97)	# of Cities Providing Services (Based on More Recent Data)
1	38	43
2	46	46
3	43	46
4	46	61
5	66	43
6	61	46
<b>Total</b>	<b>300</b>	<b>285</b>

Note: Services include: police, fire, parks and recreation, solid waste, water, and sewer. Numbers in this table based on more stringent criteria.

Sources: 1997 Census of Governments and data obtained from more recent information.

Table 21 presents a summary of city services using more stringent criteria than used in the preceding table. In this table, a city is counted as providing a service using the COG 97 data only if its per capita level of spending on the service equals or exceeds an amount equal to 50% of the median amount spent on the service by cities spending some positive amount on the service. A city is counted as providing the service using the more recent data only if available information identified the service as being at a level identifiable as “full service.” Note that only six services or functions are referenced in Table 21 since detailed data on the current level of street and highway services was not available. Based on more stringent criteria, only 61 cities could be categorized as full-service using the COG 97 data and 46 using the more current data and more stringent criteria.

The data support several generalizations about city services. Predictably, as city population rises, the number of services provided rises (based on seven services).<sup>97</sup> The data in Table 22 shows a direct positive

**Table 22. City Services in Relation to City Size**

Population	Number of Cities	Average # of Services
Over 50,000	8	6.8
25,000 - 49,000	12	6.6
10,000 - 24,999	28	6.4
5,000 - 9,999	39	6.6
2,500 - 4,999	49	5.6
1,000 - 2,499	95	4.9
Under 1,000	117	3.6
<b>Totals</b>	<b>348</b>	<b>5.0</b>

Source: Based on recent data developed and identified in municipal service section of report. All cities assumed to provide some level of street & highway services.

<sup>97</sup>Data based on some level of service, not full level of service.



relationship between city size and the average number of services provided.

Secondly, also not surprisingly, cities that have their own school systems tend to offer more services than their peers (cities of similar size without school systems). During fiscal year 2003, 27 cities operated their own city school systems. While these cities are generally large (24 had population over 10,000) and therefore already more likely to offer a full menu of services to their residents, smaller cities that run their own school systems also tend to offer more “other” services than their peers. Every city that provided some level of local education also provided at least some level of six of the seven services considered.

**Table 23. City Services by Cities With and Without School Systems**

Population	With School System	Without School System
Over 50,000	7.0	6.6
25,000 - 49,000	6.7	6.6
10,000 - 24,999	7.0	6.2
5,000 - 9,999	6.9	6.4
2,500 - 4,999	7.0	5.5
1,000 - 2,499	6.0	4.9
Under 1,000	NA	3.6
Total	6.8	4.8

Source: Based on more recent data. All cities assumed to provide some level of street & highway services. NA reflects that there are no cities in this subgroup.

Finally, and also somewhat predictably, cities that levy no property tax tend to provide fewer services than other cities of similar size. The major exception to this generalization is for cities that receive relatively large amounts of state aid, such as Hall Income Tax, which enables them to provide a few services without the need for a property tax levy.

Again referencing Table 21, the data shows that 127 of 300 cities (using the COG 97 data) and 135 out of 285 cities (using the more recent data) provide 3 or fewer full services. There is nothing intrinsically wrong with cities providing only a limited menu of services to their residents. A combination of services, some provided by a county government and some by a city government, is a legitimate choice for citizens to make. Citizens who prefer to live in a city that provides all or most services itself (generally at some enhanced level vis-à-vis county services) are free to make

<sup>98</sup>CTAS (County Technical Assistance Service) collects annual audit information from most counties. The data collected provides very specific budget code data. Most but not all counties reports this data to the Comptroller’s Office.

<sup>99</sup>The last detailed statistical report on Tennessee city finances was completed in 1997 and covered fiscal year 1995. See Comptroller of the Treasury (1997). However, the 1995 report did not provide as much detail as the 1997 Census of Governments.

<sup>100</sup>See TACIR (2000), pp. 26-37 and Appendix D, E, and F.

that choice and likely bear generally higher levels of taxation. However, the issue that this raises is that state-shared taxes subsidize this choice of limited services and a determination needs to be made concerning whether or not that is equitable.

### **Importance of State-Shared Taxes to City Government Operations**

The issue of changes to current methods of distributing state-share taxes, while controversial, would be less so if such revenue represented a minor percentage of city government revenues to all or most cities. For most counties and many cities, state-shared revenue is in fact a minor revenue source. It is generally of minor importance in contrast to local property and local option sales taxes. Its actual importance to local finances is difficult to gauge on an annual basis, especially for cities. While some annual data is available with which to determine the importance of shared tax revenue for most counties,<sup>98</sup> no such annual data is readily available for cities. There exists no central clearing house or database for city finances in Tennessee.<sup>99</sup>

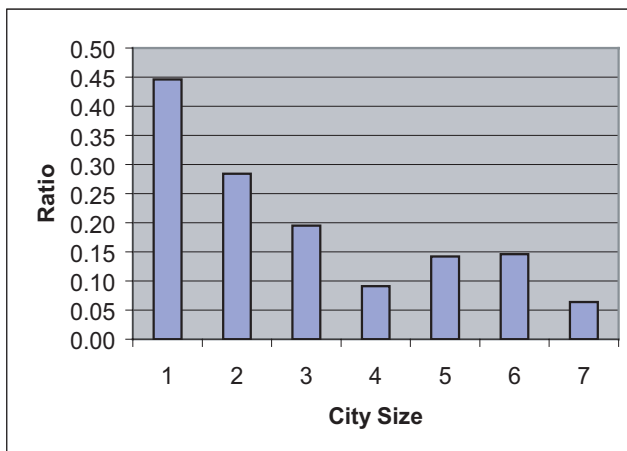
Data showing the importance of state-shared revenues to counties and a sample of city budgets was developed and presented in a March 2000 TACIR publication on state-shared taxes.<sup>100</sup> That data showed that for a few cities and counties, state-shared taxes represented a substantial portion of local government revenue. The 2000 study included some limited FY 1999 data for about 30 cities obtained through telephone interviews. The results of that limited sample showed substantial variation in the importance of state-shared taxes to local budgets. The data also showed dramatic variation in the amount of per capita tax distributions and the relatively small number of cities that account for most of the amounts distributed (see Appendix for recent per capita distributions). The COG 97 data does provide more complete information with which to evaluate the question of the importance of state-shared taxes to cities.



populations of 2,500 or less show much lower levels of spending per \$1 of state highway aid than other cities. While there is extensive variation in the relative spending (per \$1 of state aid) by cities in all of the city-size categories, city size does not appear to affect the median level of spending once city size reaches over 2,500 population. On average, the cities spent \$2.20 of local money for each \$1.00 of state highway aid funds.

**Evidence on the Importance of State-Shared Taxes for Other City Expenditures**

**Figure 2. City Dependence on Shared NonHighway Revenues, by City Size (COG97 data)**



Similar conclusions are reached when the data is used to analyze the importance of state-shared revenues that exclude road and street spending. Figure 2 shows that city dependence on state-shared revenues (measured by the median ratio of state-shared non-highway revenues to city non-highway expenditures) declines by city size.<sup>105</sup>

This data reflect that many small cities, especially cities with populations under 1,000, rely heavily on state revenues for much of what they do. Of the 28 cities that have calculated ratios above 1.00, 19 had populations (1996) of less

than 1,000, 6 had populations between 1000 and 2,499, and 3 had populations between 2,500 and 4,999.

**Evidence on the Importance of State-shared Taxes to Cities With and Without Property Taxes**

How important are state-shared taxes to cities with and without property taxes? Does this importance vary by city size? This question is evaluated using the same approach used in the previous section. The ratio of state-shared non-highway taxes to city non-highway expenditures is calculated for each city.

<sup>105</sup>Dependence for each city is measured by the ratio of state-shared non-highway revenue to non-highway expenditures. The ratios were then grouped by city size (categories 1-7), and the median ratio for each of the 7 city categories identified and used as a measure of dependence in accompanying charts

The data is then divided into two major groups: cities with a property tax (during FY 1997) and cities without a property tax. Each of these groups is then categorized by city size. Dependence was then measured using the median ratio for each subgroup. Since cities without property taxes fell into only two city size groups (<1000 or 1000<2500), the table is fairly short.<sup>106</sup> The table clearly demonstrates that cities that do not impose property taxes are more dependent on state-shared taxes than cities of similar size that do impose property taxes.

**Table 25. Dependence on State-Shared Taxes  
Median Ratio (in Percentages) of Shared Taxes to  
Expenditures**

City Size	With Property Tax	Without Property Tax
<1000	33.2% (75) [8.9% - 205.5%]	74.5% (55) [11.5% - 566.6%]
1000<2500	25.2 % (67) [5.3% - 383.9%]	36.0% (21) [5.1% - 308.3%]

Source: COG97 city data. Numbers in parenthesis reflect number of cities. Numbers in brackets reflect the range of values for each group.

## COUNTY GOVERNMENT IN TENNESSEE

County governments in Tennessee are required (by a combination of mandates in the State Constitution and state statutes) to provide certain basic services to their residents. Because of these state mandates, the number of services provided by each county is fairly similar (in stark contrast to the distribution of services provided by cities). While the number of services is fairly consistent across counties, the per capita amount spent on each service varies extensively for two reasons: (1) in some counties, services provided by some cities, such as for education, streets and roads, solid waste, and others reduce the service load for these services on county governments (these services must be provided only to county residents living outside cities); and (2) the desire by some counties to spend more intensively on some services. The major mandated county services include:<sup>107</sup>

<sup>106</sup>Seventy-six (76) of the 80 cities that did not impose property taxes during fiscal year 1997 (and were included in the COG 97 dataset) had populations of less than 2,500 (1996). Therefore comparisons were made only for the two smallest city size categories. The four cities not included in the comparison (since there were too few in any given city size category for a meaningful comparison) were Farragut, Forest Hills, Mt. Juliet, and Oak Hill.

<sup>107</sup>List provided by Mr. Ron Fults, Director of Legal Services, County Technical Assistance Service.

- An education (K-12) system (capital investments as well as operations and maintenance);
- Jails and/or workhouses (includes construction, operation and maintenance, as well as medical care of prisoners housed in such facilities);
- Law Enforcement (operation of a Sheriff's Department)
- Court system (construction, operations, and maintenance), including operations of the office of Clerk and Master, Juvenile and General Sessions Courts;
- County highways, streets, and bridges (construction and maintenance);
- Solid waste program;
- Operation of Constitutional County Offices (in addition to some included above) such as county executive, county clerk, register of deeds, assessor of property, and county trustee;
- Emergency Management Operations (counties can have a joint operation of this service);
- County Medical Examiner Office;
- Election Commission and its operations;
- County health department, operations, and facilities;
- Other county boards and commissions such as county legislative body, county board of equalization, etc.

Detailed fiscal data for county governments is available from two sources:

1. Census of Governments (1997).<sup>108</sup>

---

<sup>108</sup>The Census data includes information for 93 counties. Nashville and Davidson County Metropolitan Government and Lynchburg and Moore County Metropolitan Government are treated as cities in the Census of Governments surveys.



2. Detailed revenue and expenditure data for 87 counties<sup>109</sup> from audit information supplied by counties to the Division of County Audit (Comptroller's Office).

The data made available from the Division of County Audit is available on an annual basis and is quite extensive but excludes 8 counties that have their audits completed by private auditors. This data from County Audit is generally analyzed by CTAS, which augments the data provided by County Audit with data from published reports provided by the 8 counties that do not utilize the Division of County Audit to perform their audits. Because of the complex nature of this data and existing time constraints, this data was not used to produce the statistical information on counties that follows.

The following statistical picture of county governments was based on COG 97 data. A more detailed description of the scope and limitations of the Census of Governments survey and procedures is included in the Appendix.

## **EDUCATION**

All counties in Tennessee are required to operate a school system unless all students can be served by some other system in the county.<sup>110</sup> However comparisons of per capita spending must be carefully evaluated given that 27 cities and 15 special school districts also provide education services. Clearly per capita county spending will be less in counties with city (and or special school districts) than in counties which have only county systems.

The COG 97 survey of county governments included 62 counties with a single school system. Total education spending by these 62 counties was \$1.5 billion. Per capita spending varied from a low of \$543 in Lake County to a high of \$964 in Hancock County. The median per capita level of spending was \$721. Other high per capita levels of spending were reported by Lauderdale (\$846),

<sup>109</sup>Davidson, Shelby, Hamilton, Knox, McMinn, Hamblen, Sumner, and Washington Counties use private auditors for their annual audit reports

<sup>110</sup>Gibson County has no county system. Students there attend one of the four special school districts in the county or the Humboldt city system. Carroll County operates a limited service school system. Regular academic instruction is provided by one of the five special school districts in the county.



Madison (\$860), Pickett (\$889), and Haywood (\$890). Total education spending by county governments was \$3.0 billion.<sup>111</sup>

### ***FIRE PROTECTION***

Fire protection includes all expenditures for firefighting and fire prevention, including payments to volunteer fire units and expenditures for ambulance and paramedic services operations. Since many cities offer their own fire protection services, per capita county expenditures in counties with large cities are expected to be low relative to expenditures in counties with few or small cities.<sup>112</sup>

Eighty-two (82) counties reported spending a total of \$24.5 million on fire protection. In some counties, fire services are supplied by special fire districts (separate from county government). Per capita spending varied from a low of \$ .04 in Blount County to a high of \$24.87 in Hamilton County. The median per capita level of spending was \$2.26. Other counties reporting high levels of per capita spending include Lewis County (\$9.20), Decatur County (\$9.23), and Bradley County (\$12.50).

### ***POLICE***

The COG 97 county expenditure data for “police” includes<sup>113</sup> county police agencies, law enforcement activities of sheriff and constable offices, coroners, medical examiners, vehicle inspection activities, and traffic and safety activities. The survey asked that correction activities be reported in a separate category (see below).

Ninety-three (93) counties reported spending a total of \$153.8 million on this category. Per capita spending ranged from a low of \$4.11 in Houston County to a high of \$209.48 in Clay County. The median per capita amount of spending was \$28.91. Other counties reporting high levels of per capita spending included Trousdale (\$77.41), Henry (\$56.12), and Robertson (\$54.65).

---

<sup>111</sup> Note that total education spending including cities and Special School Districts was close to \$4.1 billion.

<sup>112</sup> Since the county is generally not obligated to supply fire protection services to residents living in such cities.

<sup>113</sup> Census of Governments survey form F-28.

## **CORRECTIONS**

The COG 97 county expenditure data for “corrections” includes operation and maintenance of correctional facilities, reformatories, and detention facilities (adult and juvenile). This category includes the operations of sheriff departments to the extent that they are related to corrections, probation, and parole activities.

Eighty-eight (88) counties reported some spending on the corrections category.<sup>114</sup> Total reported spending by these counties was \$151.9 million. Per capita spending varied from a low of \$ .45 for Carter County to a high of \$78.06 for Hancock County. The median per capita amount of spending was \$15.36. Other counties reporting high per capita levels of spending were Shelby (\$76), Carroll (\$65.33), and Knox (\$47.07).

## **TRANSPORTATION-HIGHWAYS**

This category includes maintenance of county roads, sidewalks, bridges, and toll facilities. It includes street lighting, snow removal, highway engineering, control, and safety. The formula for distributing gasoline and motor fuel taxes to county governments is based one-fourth on population, one-fourth on county area, and one-half equal shares.<sup>115</sup>

Ninety-one (91) counties<sup>116</sup> reported spending a total of \$ 211.7 million on this category. Per capita spending ranged from a low of \$12.90 in Shelby County to a high of \$246.78 in Van Buren County. The median per capita amount of spending was \$69.11. Other counties reporting high levels of per capita spending include Perry (\$205.21), Hancock (\$174.88), and Clay (\$167.01). The distribution of per capita spending on roads and highways correlates closely with the per capita amounts of shared highway taxes that the state distributes to counties.

<sup>114</sup>The following counties did not report any spending on this category: Chester, Grainger, Hickman, Marion, and Robertson. These counties may have reported correction spending under the police category, or lumped it into a catchall category called “all other.”

<sup>115</sup>See Appendix Table A-6 for the results of some alternative formulas.

<sup>116</sup>Lewis and Union were excluded because of what appeared to be erroneous expenditure data.

### **GOVERNMENTAL ADMINISTRATION-JUDICIAL AND LEGAL**

This category<sup>117</sup> includes the current operating expenses of all county court and court-related activities including juries, probate officials, prosecutors, bailiffs, marshals, public defenders, county attorneys, legal departments, and court activities of sheriff's department.

Ninety-three (93) counties reported spending a total of \$124.8 million on this category. Per capita spending ranged from a low of \$8.02 in Warren County to a high of \$54.45 in Shelby County. The median per capita amount of spending was \$16.99. Other counties reporting high levels of per capita spending include Knox (\$39.12), Benton (\$38.65), and Clay (\$37.82).

### **SOLID WASTE MANAGEMENT**

This category includes all current operating expenditures on street cleaning and the collection and disposal of refuse and garbage.

Ninety-two (92) counties<sup>118</sup> reported spending a total of \$68.7 million on this category. Per capita spending ranged from a low of \$.62 in Carter County to a high of \$105.01 in Clay County. The median per capita amount of spending was \$17.41. Other counties reporting high levels of per capita spending include Maury (\$84.86), Robertson (\$65.93), and Fentress (\$59.37).

### **PARKS AND RECREATION**

This category includes spending on playgrounds, golf courses, swimming pools, museums, marinas, community music, drama, celebrations, zoos, and other cultural activities.

Seventy-six (76) counties reported spending a total of \$25.3 million on this category. Seventeen (17) counties did not report any spending on this category.<sup>119</sup> Per capita spending for the 76 reporting counties ranged from a low of \$.04 in Sumner County to a high of \$23.02 in Haywood County. The median per capita

---

<sup>117</sup>COG 97 survey also provides expenditure information for financial administration, general county buildings, and central administration.

<sup>118</sup>Dyer County did not report any expenditures on this category.

<sup>119</sup>Campbell, Cheatham, Clay, Coffee, De Kalb, Dickson, Dyer, Fayette, Greene, Grundy, Hancock, Lake, Lauderdale, McNairy, Polk, Rhea, and Robertson.

amount of spending was \$1.40. Other counties reporting high levels of per capita spending include Hamilton (\$19.33), Williamson (\$15.03), and Knox (\$14.05).

**HEALTH**

This category includes operating expenditures on all public health activities except hospital care.

Ninety-three (93) counties reported spending a total of \$130.8 million on this category. Per capita spending ranged from a low of \$1.46 in Lincoln County to a high of \$152.12 in Clay County. The median per capita amount of spending was \$20.84. Other counties reporting high levels of per capita spending include Cheatham (\$136.52), Pickett (\$66.91), and Rutherford (\$52.26).

**IMPORTANCE OF STATE-SHARED TAXES TO COUNTY GOVERNMENT OPERATIONS**

In contrast to most cities, state-shared taxes are not a significant source of revenue for funding county government operations. While many counties are dependent on state-shared highway revenue for funding their local highway programs, state general support aid<sup>120</sup> represented less than 5% of total county revenues<sup>121</sup> for 87 of the 93 Tennessee counties included in the 1997 survey of county governments.

<b>Category</b>	<b>Direct Current Expenditures (In Millions of Dollars)</b>
Governmental Administration	\$ 314.3
Police	153.8
Fire	24.5
Corrections	151.9
Transportation-Highways	212.1
Education	2,608.9
Health (exclude hospitals)	130.0
Hospitals	1,157.6
Libraries	17.8
Social Services	75.9
Environment & Housing	115.5
Interest on General Debt	268.2
All Other	149.4
<b>Total</b>	<b>\$ 5,380.0</b>

*Note: COG97 data excludes utilities and capital outlays.*

<sup>120</sup>Primarily state-shared taxes that are not earmarked for specific programs or purposes.

<sup>121</sup>Total revenues used in the calculations included (1) all local tax revenues, license permit fees, and (2) state and federal intergovernmental revenue. For detail, see Census of Government survey form F-28, pp.1-2.

Only 6 counties had a calculated dependence on state general support aid in excess of 5%. Of those, none exceeded 10%.<sup>122</sup> The 6 counties (and their calculated dependence on state general support aid) are Stewart (9.6%), Benton (6.2%), Lake (5.9%), Hickman (5.8%), Carroll (5.3%), and Perry (5.1%). Stewart, Benton, and Perry rank 1, 2, and 3 in per capita TVA fund distributions.<sup>123</sup>

An issue addressed in the previous section on city government finances was the importance of state-shared highway taxes to city spending on streets and roads. The same issue is applicable to counties. Based on the COG 97 data, the following observation applies to counties:

- On average, for every dollar of state aid given to counties for highways and roads, counties contributed an additional 32 cents of their own money toward highway and road expenditures.<sup>124</sup> Therefore the COG 97 data shows that counties tend to augment state-shared highway funds at relatively lower levels than cities. Whether this results from a relatively higher level of state highway aid to counties, or relatively higher road costs in cities, is not clear.

## THE MOST APPARENT INEQUITIES

### *INTRODUCTION*

This analysis has not discovered any universal principles of equity as the concept pertains to state-shared taxes. The most common principle of equity is based on population or per capita distributions, since the number of people is considered a convenient proxy for local government service level needs. This principle goes to the issue of “horizontal equity” that promotes equality among equals and assumes that this equality reflects the

---

<sup>122</sup>Cocke County had a calculated ratio of 10.8%. When the COG 97 data for Cocke County was checked, the reported amount of general support aid was found to be in error.

<sup>123</sup>Based on FY 2003 data.

<sup>124</sup>Based on COG 97 data for 91 counties (2 out of the 93 counties responding to the survey had clearly erroneous data for state highway aid). See Appendix Table A-7.

needs of the community. The vertical equity principle would recognize that the needs of individuals and communities vary.

The population principle of equity was recognized in the old Federal revenue-sharing formula, the Michigan revenue-sharing reform of 1999, the findings of the Tennessee Tax Modernization and Reform Commission, and several tax-sharing formulas in Tennessee (mostly affecting cities).

In addition to population, the TTMRC recommended that tax effort and tax capacity be used, as well as an entirely new formula for the distribution of gasoline and motor fuel taxes. However, there are several examples that ignore these principles.

### ***CITIES WITHOUT PROPERTY TAXES***

In 2002, there were 84 cities in Tennessee that received state-shared taxes but made no or minimal fiscal effort, as reflected by the fact that no property taxes were collected. This is particularly significant because the property tax is the primary source of revenue for both city and county governments.

Based on data from COG 97, 74 of these cities offered only 4 or fewer services (either directly or contracted); 60 offered 3 or fewer services; and 39 offered 2 or fewer services. None offered as many as 6 services.

Cities without property taxes tend to be small in population, offer few and low quality services, and rely disproportionately on state-shared tax revenue.

### ***GASOLINE AND MOTOR FUEL TAXES (COUNTIES)***

One of the most glaring examples of inequity is the state tax sharing formula for county roads and highways. This formula requires funding on the following basis:

- One-fourth: population
- One-fourth: county area
- One-half: equal shares

As a testament to this formula, it should be noted that it was adopted in 1931 and has not changed in 72 years. The population and county area components could be described as “equitable”

because population is a general equity principle and county size may reflect the need for roads (but not necessarily). However, equal shares among governmental units have no basis in equity. This means that for 50% of the revenue distributed under the gasoline and motor fuel tax formula, Pickett County and Shelby County receive exactly the same amount. Moreover, there is no correlation between equal shares and county population and very little correlation between county population and county area.

The TTMRC recognized a clear dissatisfaction on the part of some counties and cities with both the “equal share” factor and the “area” factor in the distribution formula for county highway funds. Clearly both tended to discriminate against urban areas in the distribution of state-shared highway taxes.<sup>125</sup> Their ultimate recommendation was to modify the existing distribution arrangement over time to one that eventually would be based primarily on population. They recommended a slow phase-in to avoid “a drastic shift to rectify the (existing) inequity completely in one step.”<sup>126</sup> Their recommendation was to immediately reduce the importance of the equal share factor from 50% to 33 1/3%, raise the importance of the remaining two factors to 33 1/3% and apply these new factors to a base year (originally 1973). Growth in the county road fund (above the level of 1973) in future years was to be distributed wholly on the basis of population. At the time, they estimated that within 12 years, two-thirds of the amount distributed to counties would be based on population.

### ***HALL INCOME TAX***

Three-eighths of the Hall Income Tax is distributed to cities and counties. The basis of distribution is situs: it is returned to the residential community of the taxpayer.

Given the history of the tax as an intangible property tax, it may be appropriate to return a portion of the tax to the taxpayer’s community. However, there is no equity principle that supports a collection situs distribution basis.

---

<sup>125</sup>TTMRC (1974a), p. 41.

<sup>126</sup>Ibid. p. 47.



### **TVA PAYMENTS IN LIEU OF TAXES (COUNTIES)**

The share of TVA payments for county governments is distributed on the following basis:

- 43%: population
- 43%: on acreage
- 14%: land owned by TVA

As was true for the highway fund distribution, there does not appear to be any meaningful relationship between the service level needs of recipients and the amount distributed to them. While a share of the distribution to counties appears to be related to the amount of TVA land owned in Tennessee (and therefore not subject to property taxation), almost 50% of the total amount distributed under this section of the law goes to 7 counties (Hamilton, Union, Roane, Humphreys, Henry, Benton, and Stewart).

### **PREMIER TYPE RESORT AREAS**

The cities of Gatlinburg and Pigeon Forge are the only “Premier Type Tourist Resorts” in Tennessee, both located in Sevier County. An analysis of tourism as an economic sector (payroll and per capita sales in the “Leisure and Hospitality” industries) indicates that tourism is a dominant economic force in Sevier County. For example, tourism industry sales in Sevier County as a percent of all industry sales in Sevier County is nearly 21% compared to a statewide average of 2.2%. Moreover, per capita tourism sales in Sevier County are the highest in the State.

However, tourism sales in Sevier County are less significant by other comparisons. Davidson County looms large with over 29% of total statewide tourism sales. Sales are also high in Shelby (22.7%), Knox (5.6%), and Hamilton (5.4%). Sevier County ranks third in the state after Davidson and Shelby with tourism sales at 10.7% of the total.

**Table 27. Tennessee's Top 5 Counties in Tourism Sales, 2001**

<b>County</b>	<b>Annual Expenditures</b>	<b>Percent of State</b>
Davidson	\$ 2,903,600,000	29.4%
Shelby	2,244,510,000	22.7%
Sevier	1,055,720,000	10.7%
Knox	549,760,000	5.6%
Hamilton	529,710,000	5.4%
All Other Counties	2,589,070,000	26.2%
<b>Total Statewide</b>	<b>\$ 9,872,370,000</b>	<b>100.0%</b>

Source: *The Economic Impact of Travel on Tennessee Counties 2001, A Study Prepared for the Tennessee Department of Tourist Development by the Research Department of the Travel Industry Association of America, June 2003*

This classification of “Premier Type Tourist Resorts” allocates a special, non standard share of the state sales tax to these two cities. During FY 2003, the following distributions were made:

	<b>Premier Resort Formula</b>	<b>Based on Population</b>	<b>Difference</b>
Gatlinburg	\$2,080,560	\$204,472	\$1,877,088
Pigeon Forge	\$3,468,451	\$311,164	\$3,157,287

Analysis of city services indicates that these two cities are “full service” cities in every respect and much more. Additionally, the number of city employees is four to five times greater than comparable size cities. Moreover, they are able to maintain this superior level of city services with very low property taxes.

Of the 264 cities that levy property taxes (2001), Gatlinburg and Pigeon Forge ranked 263<sup>rd</sup> and 264<sup>th</sup>, respectively. Property tax rates are also low for the cities of Pittman Center (rank: 258<sup>th</sup>) and Sevierville (rank: 262<sup>nd</sup>).

Relative to the local sales tax, the Sevier County rate is 2.5% compared to the State average of 2.4%. Neither Gatlinburg nor Pigeon Forge impose a higher sales tax rate than the county rate. Thirty-two (32) counties have sales tax rates higher than 2.5%. Relative to hotel/motel taxes, Gatlinburg has a rate of 3% and Pigeon Forge has a rate of 2.25% and Sevier County has no such tax. This compares with 8% for Adamsville in McNairy County; 32 other Tennessee cities have rates above 3% and 28 cities have rates at 5%.

Another local tax used by governments in Sevier County is the local business tax. Ninety-three (93) counties levy the tax and 90 levy the maximum rate. Of the 348 cities, 199 levy a business tax and 164 (including Gatlinburg and Pigeon Forge) levy the maximum rate. Gatlinburg and Pigeon Forge generate the second and third largest per capita local business tax revenue in the State. Among the counties, Sevier is number one in per capita revenue.

In summary, it appears that the additional funds authorized Gatlinburg and Pigeon Forge by the “premier type tourist resort” exception, in combination with revenue generated from the local option sales tax, and the relatively large presence of commercial

and retail property in these cities, allows these two cities to provide very high levels of services with minimal property tax rates.

### ***CITY VERSUS COUNTY DISTRIBUTIONS***

Why should the total amount of state-shared taxes distributed to county governments be less than the amount distributed to city governments? No equity principles were discovered that would directly address this issue. However, county representatives tend to view this as a matter of equity, particularly involving the sharing of the state sales tax.

It should be noted that in 1970, city and county governments received almost equal amounts of total state-shared taxes. For FY 2003, city governments received a total of \$384 million compared to \$269 million for county governments (not including wholesale beer tax).

### ***CITIES THAT PROVIDE LIMITED SERVICES***

There were 77 cities (or towns) in Tennessee in 1997 that offered 3 or fewer services to their residents and only 122 that offered at least 7 services. Current state law (PC 1101) requires that all new incorporations provide a plan of services for a minimum of 7 services and produce local funding equal to state-shared taxes. Based on COG 97 data, 222 cities do not meet the PC 1101 standard.

# STATE TAX SHARING, FAIRNESS, AND LOCAL GOVERNMENT FINANCE IN TENNESSEE

---

## Major Contributors to this Report

Harry Green, Ph.D.  
Executive Director

Stan Chervin, Ph.D.  
Public Finance Consultant

Ed Young, Ph.D.  
Research Consultant

Susan Mattson, M.P.A.  
Research Consultant

Teresa Gibson  
Publications Associate

## Other Contributors to this Report

Lynnisse Roehrich-Patrick, J.D.  
Director of Special Projects

Libby Thurman, M.A.  
Senior Research Associate

Daniel Merchant, M.S.  
Senior Research Associate

Rose Naccarato, M.A., M.P.P.  
Senior Research Associate

Katy Blasingame, B.S.  
Research Assistant