The Increasing Difficulty in Financing Cities

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It's getting harder to fund city government in North Carolina.

On the one hand, that might seem hard to believe. People continue to flock to many cities and towns across the state. More than half of the state's population lives in a municipality. One recent projection from American City Business Journals sees the Raleigh and Charlotte metropolitan areas alone adding nearly 3 million people in the next 25 years. Those newcomers who choose to live in city limits will join existing city residents in paying city property taxes, and join all those who shop in North Carolina in paying sales taxes that cities receive a share of.

But all of these current and future residents demand city services too. The citizens and the businesses they work for want clean water, and good roads, and responsive police and fire departments, and timely trash pickup, and reliable public transit, and parks and other amenities that provide the quality of life that helped attract them in the first place. And North Carolina cities are particularly limited in the options they have to fund all these services.

Some of these limitations have come about in recent years because of changes in laws or interpretations of laws. City authority to charge license fees to businesses was eliminated in 2014. Beginning next year, municipalities will be unable to charge certain utility companies fees that help offset the increased costs of permit processing that their work requires. And earlier this summer, the N.C. Supreme Court handed down a ruling that could prevent cities from charging new water and sewer customers fees designed to pay for the increased demand they place on utility systems, potentially requiring significant increases in water and sewer fees around the state.

But some of municipalities' revenue limitations are not recent changes. Some are structural elements of North Carolina's tax and finance picture that leave the state's cities with only one source of general purpose revenue that they control: the property tax.

Take the sales tax, for instance. In North Carolina, all sales taxes are levied at the county level. Counties must share a portion of the first 2 cents of sales taxes with cities. But the counties themselves are in sole control of choosing the method in which the sales tax is shared. This results in a sales tax system in which the most recent data available shows that approximately three-quarters of sales tax-generating sales occur within municipal limits, but cities only receive roughly one-third of sales tax revenue. As Whitney previously noted in this very space, all counties also have the authority to levy at least an additional quarter-cent of sales tax, and they are not required to share any of this revenue with the municipalities within their borders.

(To be clear, cities across the state have great relationships with our county partners, and counties share at least partial funding responsibility for schools and social services, two major areas of expense that cities are not required to fund. And unlike in Virginia, for example, all city residents are county residents as well. This explanation is merely meant to show that N.C.'s sales tax system is much more complex than one in which you can assume that paying a dollar of sales tax within a city means that the city will receive that whole dollar. Far from it.)

This system also makes North Carolina something of an outlier from a national perspective. According to the Tax Foundation, 38 states nationwide authorize some form of local option sales taxes. And turning again to Whitney and her co-authors from the School of Government, of these 38, 30 states authorize municipalities to levy their own local option sales taxes. Only three other states across the country limit sales tax authority just to county governments.

But cities do at least receive some unrestricted revenue from local sales taxes. Other revenue sources are far more restricted, or prohibited entirely. Cities in other states around the country have the authority to levy local income taxes. In North Carolina, only the state may levy an income tax. Room occupancy taxes in North Carolina are established via local acts that virtually always require more than half of the revenues be devoted to marketing and tourism promotion. At least three other states in the Southeast allow local gas taxes. North Carolina's gas tax is a state tax that the State has been willing to share with its cities, but it is not strictly a local revenue.

All of this means that as cities continue to add people and businesses that require more and more services, they have little choice to fund these services outside of raising property taxes. Until now, cities have managed their growth while maintaining relatively low property taxes. (This is, by the way, one of the reasons so many people are moving to North Carolina.) The Tax Foundation ranks North Carolina 33rd nationally in property tax rates. The N.C. League of Municipalities is helping cities highlight the many ways they have effectively invested their limited revenues in local businesses and residents through its Here We Grow campaign, which you can check out here.

But like an investor trying to diversify her portfolio, cities need to be able to diversify their revenue streams in order to keep property taxes low and keep revenues stable through good economic times and bad. Diversification requires legislative authority, though, and the League will continue to be working with its partners in the General Assembly on ways to allow cities to be able to select revenue options that make sense for their residents and their businesses.

People are moving to North Carolina, and more specifically, they're increasingly moving to North Carolina's cities. Thus far, cities have managed this influx of people with existing limited revenue streams, and national ranking after national ranking list some of North Carolina's cities as among the best in the country. By diversifying cities' revenue streams and allowing them to expand their financial options, we can keep it that way.

My thanks to Whitney Afonso for inviting me to serve as a guest blogger. She said I could write about anything I want, so any complaints can be directed to her. Compliments may be sent to cnida@nclm.org.