MUNICIPAL REVENUES

AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

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Financing Cities

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Does local public finance matter for the economic success of cities? If it does, how should we finance the provision of public services to city residents and firms? This is the agenda of this chapter and this volume. This chapter provides a framework for these important discussions. To do so, four questions are addressed. First, why cities? Cities are essential centers for the efficient production and consumption of goods and services; well-run and productive cities are not easily replicated. Second, what is the role of local public finance for city productivity? Firms and residents need public services to be productive; if such services are not efficiently financed and provided, the city's economy will suffer, and productive output will be lost. Third, what principles should we adopt for the efficient provision of public services to firms and households? I stress the advantages of choice by households and firms and the need to create incentives for the providers of local services to do so at the lowest cost, including the economic costs of financing. Fourth, what about fiscal equity? While fiscal efficiency should be a city government's primary concern, fiscal fairness need not be ignored. The chapter concludes with a set of recommendations for the efficient and fair financing of city services.

Why Cities?

Both historically and in terms of the analysis of the current determinants of country growth, cities are essential to national prosperity.[1] Why is this true? The

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1. On the historical importance of cities to economic growth and prosperity, see Hohenberg and Lees (1985). For contemporary evidence on the importance of cities to country economic growth, see Henderson (2003).

answer lies in the economic advantages of proximity, what is known as agglomeration economies. There are three kinds of agglomeration economies. First is Marshallian agglomeration, named after the British economist Alfred Marshall, which stresses the advantages of proximity for firms in the same industry. There are two such advantages. The first is the economies of scale in transportation: large shipments to many firms will be significantly less expensive than small shipments to one firm. The second is the advantage of a large pool of workers who can move from firm to firm to accommodate ups and downs in the production cycles of individual firms. The concentration of steel firms in Pittsburgh and Gary, of country music in Nashville, and of the production of movies and entertainment generally in Los Angeles are examples of efficiency because of Marshallian agglomeration.

Second is Jacobian agglomeration, named after the social critic and urban scholar Jane Jacobs, which stresses the benefits to firms of sharing ideas within the same industry and, equally important, across industries. Idea sharing leads to more efficient production and to new products. The proximity of hardware and software firms in Silicon Valley, of hospitals and of bioengineering and pharmaceutical firms in Philadelphia and Boston, and of firms designing dress, accessories, and toiletries in Paris and Milan are all examples of the benefits of Jacobian agglomeration.

Third is consumption agglomeration, which stresses the advantages of having many firms in a single location to satisfy households' demands for product quality and product variety. Only large cities can offer Chinese, Indian, Mexican, French, Italian, German, Thai, and Ethiopian food along with the usual comfort foods that Mom used to cook.

The physical area needed to realize the full potential of Marshallian, Jacobian, and consumption agglomeration economies is not large, perhaps no more than one to two miles on a side for Marshallian production agglomeration and perhaps much less for Jacobian idea agglomeration. A recent study by Vernon Henderson of the relocation of New York City advertising firms from Madison Avenue to less expensive locations in the city's West and East Villages showed the firms "agglomerated" within 600 to 800 yards of each other, distances of not much more than three to four city blocks.[2] Further, the benefits of agglomeration may be most important for small independent firms. In their analysis of the productive efficiency of computer manufacturers, Mark Beardsell and Vernon Henderson (1999) found that the primary beneficiaries of proximity in terms of higher overall productivity were small independent plants, not plants affiliated with large manufacturers. Why? Managers of independent plants got their new ideas from their geographical neighbors; managers of affiliated plants learned from other managers within the large corporation, perhaps 1,000 miles away.

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2. For evidence on this important point, see Rosenthal and Strange (2003); Henderson (2008).

How do cities facilitate the productive advantages of agglomeration? Cities provide to firms and households what private markets do not. Households, workers, and goods must be able to access these efficient production and consumption centers, and that means roads and transit networks. Firms within these centers must be able to dispose of waste from the production process, and that means sanitation and sewage systems. Firms and workers will need clean water, which means municipal waterworks. Since training workers in basic skills and ensuring their overall health creates a public benefit for all firms accessing the labor pool, public education and public health are necessary. Finally, firm and household property needs to be protected, which means police and fire services. None of these important services are efficiently provided by the marketplace, either because of significant economies of scale (and thus the risk of monopoly pricing) or because of important external benefits across all firms and households in the agglomerated area. The answer for each market failure is public provision in the local area. This is the role for city governance and local public finance.

Does Public Finance Matter? A Tale of Two Cities ─────────

The recent economic fortunes of two U.S. cities clearly illustrate the importance of efficient city government. In 1950 St. Louis and Pittsburgh were similar in size, with about 700,000 residents, and both were successful manufacturing centers. The two cities had nearly identical income levels, poverty levels, and crime rates. Since 1950 both cities have experienced the contraction of manufacturing common to all our older industrial cities, and as a result both are half as large today as they were in 1950. Beyond that, the similarity ends. Today, the average resident's income in Pittsburgh is 30 percent higher than that in St. Louis, the poverty rate is about 30 percent lower, and the crime rate is half the rate of St. Louis. On almost any dimension, Pittsburgh today is a more attractive city than St. Louis.

An important difference between the two cities was how city government managed the city's economic contraction. Beginning in 1970, as the contraction in Pittsburgh's manufacturing economy became apparent, Mayor Peter Flaherty began to downsize the government in proportion to the city's declining population. As the tax base shrank, so did the government's total spending demands on that tax base. Thus, tax rates and service levels remained stable. In contrast, St. Louis did not shrink its city government in proportion to the decline in the economy.[3] As a consequence, tax rates rose. This led to the exit of middle-class

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3. In fact, matters were a bit more troubling in St. Louis. As a young assistant professor, I joined a senior colleague on a consulting trip to advise the mayor of St. Louis about what the city might do to improve the performance of its government. When we asked to see the city budget, we were told there really wasn't a city budget, just a stack of separate requests from each city department that were fully funded by increasing tax revenues. We suggested that an overall budget might be a good place to start. We provided a framework for developing such

households and mobile service businesses to the suburbs, further exacerbating the fall in the city's tax base, necessitating another rise in tax rates. Today, Pittsburgh is the center of a successful regional service economy with two major research universities and a thriving high-tech and biomedical economy. The growth of the St. Louis regional economy is now taking place in its suburbs. The lesson of this comparison applies more generally.

The Principles of Efficient Local Public Finance

Three conditions must be met for city public finance to be efficient. First, city governments should be asked to provide only those services they can do well. Second, city governments must have the fiscal tools necessary to meet their service responsibilities at the lowest cost possible, including the economic costs of taxation. Third, the institutions of city governance must provide correct incentives to ensure that city officials provide services efficiently and use efficient taxation.

GETTING CITY RESPONSIBILITIES RIGHT

Successful cities provide public services and infrastructure that complement private capital and labor in production and create the physical and social environments valued by city residents. Whenever possible, services should be provided by the private market, but often private firms need help from the public sector for efficiency to be achieved. For example, a firm can educate its workers, but if educated workers leave the firm for employment elsewhere, the firm's investment is unprofitable. Thus, cities should provide education in general skills, and firms can then provide training in firm-specific skills. Often efficient provision of the valued service requires a large fixed cost—for example, transit and communication networks, safe water, clean environments, safety of persons and property. Large fixed costs will require large providers and raise the risk of monopoly power. If so, the infrastructure should be financed and owned by city government. But infrastructure maintenance and even the provision of the service might be contracted out to private firms.[4]

City government responsibilities should extend to solving failures in the private market, either because of significant external benefits (or costs) or because of significant economies of scale. Services that would qualify include K–12 education, police and fire services, libraries, open space and recreation, sanitation,

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a budget and offered the assistance of one of our graduate students to collect the relevant data and develop the needed programming for basic financial management. When the task was finished, the city hired our graduate student as the city's first finance director. He never finished his thesis, but he has gone on to have an outstanding career in government finance.

4. For guidelines on when to contract out, see Hart, Shleifer, and Vishny (1997). For guidelines on how to contract out, see Williamson (1976).

roadways, sewers, public health, water, and communication and transit networks. Services with significant spatial spillovers should be financed by higher levels of government—for example, regional transit and intercity highways, electrical power generation and networks, and airports.

What city governments should not do, at least using their own tax resources, is redistribute incomes from city taxpayers to poor residents beyond what those taxpayers themselves might prefer. City poverty burdens city residents in two ways. First, in large U.S. cities, poverty spending from the cities' own resources is $670 per capita on average, implying a tax rate increase of about 3 percent on median household income (Inman 2009, table 11.4). This added tax burden is likely to drive middle-class families from the city. Second, city poverty implies a possible increase in the costs of providing public services to taxpaying city residents.[5] Either city spending must rise, or service quality must decline. Again, taxpaying residents and firms will be tempted to leave the city. Their exit undermines the city's consumption and production agglomeration advantages. Removing the responsibility for city poverty from the city's budget is an important first step toward greater city fiscal efficiency. Outside grants to pay the costs of federal and state service mandates for lower-income families and aid for the added costs of service provision resulting from large concentrations of lower-income families are the appropriate policy response.

GIVING THE CITY THE RIGHT FISCAL TOOLS

Getting fiscal responsibilities correct is an important first step, but choosing the right fiscal tools to meet those responsibilities is crucial, too. To achieve fiscal efficiency, elected officials must have the spending tools and tax instruments needed to maximize service benefits and minimize financing costs.

Services   Labor is the most important input for providing city services, and the key spending tool for fiscal efficiency is the right to hire, assign, and, if necessary, fire public employees as effective service provision requires. Not all cities enjoy such flexibility. Some states require their cities to obtain the consent of the city's recognized public employee union to set labor policies. In these duty-to-bargain states, city unions have a monopoly right to provide public services.

One would expect the wages and benefits of such an empowered union member to exceed their competitive market alternative—and they do—and the level of employment at those noncompetitive wages to exceed the efficient level—and it does. Controlling for individual worker characteristics, public employees in strong unions earn from 5 to 15 percent more than they might have earned in their most likely alternative positions. Health care and pension benefits are significantly higher, too. There is no evidence that the unionized workers' higher

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5. For the effects of poverty on the provision of city education, see Dunscombe and Yinger (1997). For effects on resident safety, see Glaeser and Sacerdote (1999).

wages and benefits are justified by a compensating increase in worker productivity.[6] Further, strong public employee unions are able to negotiate a larger public employee workforce than taxpayers would prefer had union negotiations not been required. There is featherbedding in duty-to-bargain cities.[7]

In such cities, city residents and their elected officials need to make clear to the public unions that the unions' long-run prosperity depends on the long-run economic vitality of the city. Excessive labor contracts will lead to higher taxes and the loss of firms and households from the city. Agglomeration economies will be lost. Fiscal crises may result, as they did in New York City in 1974 and in Philadelphia in 1991.[8] Union officials must be made to appreciate the realities of this economic constraint. This position was the foundation for Mayor Edward Rendell's successful negotiations with Philadelphia's public unions at the time of its 1991 fiscal crisis; the unions understood and agreed to two years of no wage increases and significant benefit and work rule givebacks.[9]

Financing   Efficient financing of city services requires that today's services be financed by today's taxes and user fees, and that future services be financed by future taxes and user fees facilitated through the issuance of public debt. Efficient city financing should pick the mix of taxes and public borrowing that maximizes the profitability of city firms and the welfare of city residents. Possible city taxes include (1) taxes on wages earned within the city regardless of workers' residences (e.g., a commuter tax); (2) taxes on city firms' capital or profits; (3) taxes on firms' land and structures; (4) taxes on local retail sales; (5) taxes on city firms' total sales (e.g., a gross receipts tax or turnover tax); (6) taxes on residents' wages or income; and (7) taxes on the value of residents' properties.

There is a simple, but useful guideline for deciding the mix of city taxes: resident taxes for resident services; business taxes for business services. Resident wage or income taxes or a tax on resident-owned property should be used to pay for residential services such as education, police and fire protection, trash collection, and parks and recreation. User fees on residents' use of city water services and sewage services are also appropriate. Business taxes should be limited to a tax on commercial-industrial property (ideally a land tax, but closely approximated by

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6. For a review, see Freeman (1986), and for recent evidence, see Eberts (2007).

7. See Inman (1982); Zax and Ichniowski (1988).

8. See Shefter (1992) for a description of the New York crisis, and Inman (1995) on the Philadelphia crisis.

9. In a meeting with all city union leaders, Mayor Rendell made it clear that raising taxes was not an option: "We are losing our middle class, our working class, to other places. We have to increase our tax base, or we are finished." Rendell viewed raising taxes as the equivalent of placing a gun to the city's head and pulling the trigger. See Bissinger (1997, 131) and the chapters on the city's labor negotiations.

exempting firm capital). User fees for firms' use of police and fire services, trash services, water, and sewers are also appropriate. City-imposed fees for parking collected at parking meters or by taxing parking garages may provide a good approximation of city firms' use of city roads (Arnott, de Palma, and Lindsey 1991). What should be avoided at the city level are commuter taxes, taxes on local retail sales, and taxes on firms' profits or gross receipts. Each of these taxes is ultimately shifted back onto the firm as lower firm profits and, unless the city is in a particular valuable and unique location, will drive firms from the city.

Table 2.1 presents "back-of-the-envelope" estimates of the efficiency consequences of each of the major city taxes calibrated to the tax rates now used by Philadelphia. The table provides estimates of what is known as the marginal excess burden of each tax, which estimates the damage to the private economy in lost consumer surplus or producer profits from raising one more dollar of that tax.[10] The marginal excess burden sets the hurdle that city service benefits must clear to justify one more dollar of city spending financed by that tax. For example, to justify the use of another dollar of residential property taxes, city services will need to provide at least $1.20 in service benefits.[11] In setting the appropriate mix of taxes, cities should move toward those taxes with low marginal excess burdens. By these calculations, Philadelphia should lower the use of business taxes, particularly the nonresident commuter tax and the gross receipts tax, for financing residential services and, within the set of residential taxes, move the tax structure away from residential property and sales taxation and toward residential wage taxation.

Finally, nonresidents who use city services—commuters and tourists—should contribute toward funding the services they use. Here user fees and targeted excise taxes such as beach fees, parking fees, airport fees, tolls at bridges and city access points, and hotel and entertainment taxes seem appropriate. If necessary,

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10. The formula used in table 2.1 to estimate the excess burden of local taxes is a simplification of the formula that would be needed for a fully complete analysis of the inefficiencies of changes in local tax rates. The specification here ignores the interaction of taxes in separate consumer markets—consumption goods, housing, and leisure—and separate markets for factors of production—labor and capital. The points made by table 2.1 are that increased responsiveness of consumption and investment decisions to local taxation matters and will mean increased inefficiencies, and that tax responsiveness is likely to be far greater for firms than for households. This leads us to favor residential taxes for residential services and to favor taxation of inelastic inputs used by businesses (land and existing structures) and the expanded use of business fees and charges for the financing of business services.

11. Finding an adverse effect of property taxation on housing investment assumes that the property tax is a tax on housing capital. There is an alternative view of property taxation that sees the tax as a benefit tax or user fee that fully reflects the costs of a local public service. This benefit view applies when the locations of residences and residential capital are fixed in supply, say, because of local zoning. If, however, residences and housing capital can be offered in an elastic supply, then the capital view applies. That is the assumption made in table 2.1. See Zodrow (2006).

Table 2.1
Efficiency Performance of Philadelphia Local Taxes

	Nonresident Wage Tax	Gross Receipts Tax	Business Property Tax	Resident Property Tax	City Sales Tax	Resident Income Tax
Economic facts[a]	(Firm profits)	(Firm profits)	(Land/Structures)	(Land/Structures)	(Shopping)	(Labor choice)
	$\varepsilon_S = \infty$	$\varepsilon_S = \infty$	$\varepsilon_S = 2.0$	$\varepsilon_S = 2.0$	$\varepsilon_S = \infty$	$\varepsilon_S = .30$
	$\varepsilon_D = 1.5$	$\varepsilon_D = 1.5$	$\varepsilon_D = 1.5$	$\varepsilon_D = 1.0$	$\varepsilon_D = 1.0$	$\varepsilon_D = 1.0$
	t = 0.12	t = 0.07	t = 0.07	t = 0.30	t = 0.07	t = 0.04
Average excess burden[b]	$0.09/$Revenue	$0.05/$Revenue	$0.03/$Revenue	$0.10/$Revenue	$0.07/$Revenue	$0.01/$Revenue
Marginal excess burden[b]	$0.18/$Revenue	$0.11/$Revenue	$0.06/$Revenue	$0.20/$Revenue	$0.14/$Revenue	$0.02/$Revenue

[a]Economic facts for each tax specify the assumed elasticity of supply (ε_S) and the assumed elasticity of demand (ε_D) for the relevant market of the taxed good or input. The *nonresident wage tax* is assumed to be shifted back onto firm profits as taxed commuters have the option to avoid the tax by working in the suburbs; thus ε_S is the supply of capital to Philadelphia, and ε_D is the demand by capital for Philadelphia locations. The *gross receipts tax* is a tax on firm sales within Philadelphia and is assumed to shift back onto firm profits given a competitive market for the output of Philadelphia firms; thus ε_S is the supply of capital to Philadelphia, and ε_D is the demand by capital for Philadelphia locations. The *business property tax* in Philadelphia is a tax on firm land and structures and is assumed to shift back onto owners of land and structures; thus ε_S is the elasticity of supply of land and structures in Philadelphia, and ε_D is the demand by capital for Philadelphia locations. The *resident property tax* is assumed to be a tax on yearly housing expenditures specified as annual mortgage costs for a typical homeowner in Philadelphia; thus ε_S is the supply of land and housing structures to Philadelphia, and ε_D is the demand for housing by Philadelphia residents. The *city sales tax* is a tax on retail sales in Philadelphia and is assumed to shift forward to household purchasers of goods and services within the city; thus ε_S is the supply of retail services to Philadelphia residents, and ε_D is the demand for retail goods and services by Philadelphia residents. The *resident income tax* is a tax on the supply of labor by city residents, whether working within or outside the city; thus ε_S is the supply of labor by Philadelphia residents, and ε_D is the demand for this labor within and outside Philadelphia.

[b]Average excess burden is estimated as $.5 \times t/[(1/\varepsilon_S) + (1/\varepsilon_D)]$. Marginal excess burden is estimated as $t/[(1/\varepsilon_S) + (1/\varepsilon_D)]$.

residents' payments of such fees and taxes can be discounted at point of payment or later rebated.

For the financing of the construction costs of city infrastructure, economic theory is clear: tax payments should be smoothed over the productive life of the government asset through the use of long-term borrowing. Ideally, taxes on the resulting improvement in the value of city land should then be used to repay the debt's principal and interest and all ongoing costs of maintenance. The now-common use of tax increment financing (TIFs) for city capital projects illustrates the feasibility of this approach.[12] When such assessments prove difficult (what is the "reach" of economic benefits from the new sports stadium or museum?), city-wide taxes on residential incomes or property should be used to fund borrowing for residential projects and, similarly, citywide taxes on business land should be used to fund business-related projects. Debt for projects that benefit both residents and businesses should be repaid by citywide taxation on both resident and business tax bases.

City debt financing can be misused, however. A city should not be allowed to use long-term debt to finance a shortfall between current spending and current revenues. While balanced current accounts budgets are required in 49 of our 50 states—Vermont is the exception—cities can circumvent the rules by backdoor borrowings. For example, many states require the prospective budget, not the end-of-year budget, to be balanced. In such cases, current spending can be systematically underestimated and current revenues overestimated; when the deficit appears, short-term debt can be used to fill the gap. The misestimates can be repeated year after year, with all future deficits passed forward as rolled-over short-term debt. This has been a favorite solution to budget pressures in Philadelphia and New York City. Cities can move current spending onto the capital accounts by reclassifying labor costs for maintenance as capital outlays (once a New York City favorite), thus allowing long-term debt financing of salaries. Finally, cities can substitute defined-benefit pension income for current wages and then underfund their pension plans. As employee pensions have always been interpreted as a contractual obligation, such underfunding moves current labor costs onto future taxpayers.[13]

Undetected deficit financing of current services imposes one of two damaging effects on the private economy. First, if debt is to be repaid by city taxpayers, city property values will fall by the discounted present value of all required future taxes. Hidden city deficits create asset value uncertainty for new investors, which discourages future investment in an otherwise productive city's economy.

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12. On the benefits of using land taxation for the financing of public infrastructure, see Arnott and Stiglitz (1979). For a discussion of the use of tax increment financing for such purposes, see Brueckner (2001).

13. Inman (1983) provides a full description of these backdoor strategies for financing current services with future taxes.

Second, if deficits are not repaid by city residents, but rather are covered by state or national governments as a bailout, then the deficit acts as an implicit subsidy to current accounts spending. Such bailouts create incentives for excessive city spending. Monitoring of city expenditures by the state, as is now the case in Camden, New Jersey, will be required. To control the inefficient use of debt financing, states may need to regulate more carefully their cities' borrowings, either directly or through the required publication of current deficit financing as measured by generally accepted accounting practices (GAAP).

GETTING CITY INCENTIVES RIGHT

Finally, it is essential for the institutions of governance to align the interests of elected city officials with the long-run economic interests of city residents and firms. City officials will first need to know the costs and benefits of city services and then, given costs and benefits, to design budgets that maximize the net economic gains to taxpayers.

While the costs of government services are generally well known, the benefits are not. If asked, residents have an incentive to overstate the benefits from services they value and to understate the benefits from those they do not. Either of two institutions—markets or politics—may be used to extract more truthful information. When services are shared and exclusion is difficult, as with police and fire protection, public health, roads, and parks, citizens can vote directly for their preferred level via a referendum or for representatives who will determine service levels on their behalf. When services can be targeted and exclusion from use is possible, as for water, electricity, libraries, education, and trash pickup, a market process can be used and prices charged. Both politics and markets have important roles to play in providing city services.

Politics   While there is no guarantee that politics will find the efficient allocation of government services, there are circumstances when it may come close. If the tax system is efficient and residents pay for residential services, and if they vote, and if the distribution of preferences for a service or a bundle of related services is not too badly skewed, the majority-rule outcome will provide a reasonably efficient way of balancing the marginal benefits and costs of public service provision.[14] More often than not, however, decisions are not made issue by

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14. The intuition of this conclusion is straightforward. Cities should balance the sum of extra benefits created to the cost of each extra dollar spent: $\Sigma MB = MC$. Dividing both sides by the number of residents redefines the efficiency condition in per capita benefits and costs as $mb = mc$. That is, for efficiency, the marginal benefit of city services to the average citizen should equal the marginal cost to the average citizen. Competitive majority-rule voting ensures that the median, or 50th percentile, voter determines the policy outcome. If the median voter is also the average voter, as will be the case when voter preferences are normally distributed, the median voter will prefer the efficient ($mb = mc$) budget. This efficiency case for majority-rule democracy was first made by Bowen (1943). For empirical evidence that competitive local

issue or by referenda, but as part of a joint process setting an overall budget. In this case, the provision of government services will be decided by representative government; here the one who sets the agenda often dictates the political outcomes. Representative city government can take one of two forms: city council government or strong mayor government.

Council governance has a problem, however: policy gridlock. One way to escape gridlock is through legislative logrolling, allowing each legislator to submit his or her most favored project for inclusion in the budget.[15] To avoid gridlock and the risk of no new spending, legislators may choose to vote to include all new initiatives via a legislative logroll. Like groups who share the costs of lunch, such budgeting is likely to be very inefficient, and more so the more legislators who share the cost of services. For example, in the summer of 1979, the leadership of Philadelphia's then nearly all-white city council got caught seeking bribes in the federal government's Abscam sting operation. Six of seventeen council members were either convicted or forced to resign just before the city's November election. As a result, six new African American and Hispanic members were elected to the city council. It is fair to think of this result as a 33 percent increase in effective council representation for lower-income neighborhoods. The budgetary consequence of this change was a permanent 33 percent increase in citywide spending on neighborhood services and a 7 percent increase in overall city spending.[16]

The strong executive form of governance—a citywide elected executive granted broad agenda-setting powers and a line-item veto—is the preferred alternative. If the elected mayor is rewarded for adopting and implementing efficient city budgets, any project whose benefits do not exceed its costs will not make the budget agenda, or if it does, it will be vetoed (see *Streetwise Policymaking*, p. 37). As a consequence, city spending should be more efficient in strong mayor cities than in cities run by council government alone. As fiscally more efficient cities are more attractive cities, city property values should be higher in cities with a strong mayor form of governance. This is exactly what has been found in studies of the effect of city governance on local property values.[17]

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politics may give the efficient outcome in the case of school districts, see Bergstrom, Roberts, Rubinfeld, and Shapiro (1989).

15. For council governments, an alternative to logrolling is to form two strong political parties so that the majority party can hold together its winning coalition through party discipline of each council member who threatens to defect. Unfortunately, party discipline does not appear to be an effective constraint on council behavior in large U.S. cities; see Ferreira and Gyourko (2009).

16. The implied elasticity of overall city spending with respect to the increase in de facto council representation is 0.20 (= 0.07/0.33); see Inman (1995). This result for Philadelphia is similar to estimates of the effects of larger city councils on city spending from a national sample of cities; see Baqir (2002).

17. See Haughwout and Inman (2002).

Streetwise Policymaking

Philadelphia's former mayor, John Street, had formed a council of economic advisers, to which I was appointed. Mayor Street had been a member of the city council and, before that, a local ward official. At the meeting, he listened patiently to the council's ideas for improving the city's tax system, then made clear his particular view about how city politics would work during his tenure:

"You guys want to know how I make policy?" He reached into his vest pocket, took out a laminated page from the *Philadelphia Inquirer*, and unfolded it like it was a city map. The page showed the vote returns from the 66 wards of the city of Philadelphia. "Here's how I make policy. I go to the neighborhoods and they say to me, 'You know, Mr. Mayor, we are behind you 100 percent. We need a new swimming pool. We want a library. Won't you fix our street lights and how about that new stop sign?' And I say, 'Just a minute.' I then take out my laminated page and say: 'Ward 23? Behind me a hundred percent? I see 48 percent support in the last election. When your support for my administration is well into the 60 percent and I can count on you in my next election, then we can talk.' " He folded up the laminated page, put it back in his pocket, and left.

The council of economic advisers never met again.

Markets   Even in strong mayor cities, elected officials must embrace fiscal efficiency as their goal for city budgeting. Here markets play an important complementary role to city politics. In U.S. suburbs, elected mayors and school board members are typically homeowners and therefore have an economic stake in the fiscal performance of the community. Owning a home in your city is the same as owning shares in a firm; it creates a vested interest in the long-run economic performance, and thus the efficiency, of city finances. When voters and their elected representatives are homeowners, fiscal and economic incentives are aligned. Recent research provides convincing evidence that suburban communities do in fact adopt fiscal strategies that maximize resident home values, and that those strategies are fiscally efficient.[18]

It is unlikely that such incentives can be fully decisive in large-city budgeting, however. In large cities, the market-driven incentives for fiscal efficiency are diluted by the fact that city mayors are most likely career politicians who are rewarded more directly by reelection and higher office than by home value appreciation. Further, politically decisive voters who determine election outcomes in large and, in particular, poorer cities are often mobile renters, not homeowners.[19] Market-driven incentives to adopt efficient budgets can be restored, however,

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18. See Fischel (2001) for the details of the argument, and Brueckner (1983).

19. Renters bear the burden of the property tax in higher rents, but forward-shifting onto higher rents will be less than 100 percent if the supply curve of rental housing is less than perfectly elastic. Oates (2005) estimates the effect of renters on overspending to be from 5 to 10 percent for the average community where they represent 25 percent of residents. In the typical large U.S. city, the share of residents who are renters is closer to 50 percent.

through the creation of business and neighborhood improvement districts (BIDs and NIDs) within the city.

BIDs and NIDs are associations of property owners within a geographical subdivision of the city sanctioned by state law to provide services for the benefit of district businesses and residents.[20] They can be the sole providers of district services, replacing city provision, or more likely, they can offer supplemental services above the common level provided by the city government to all city neighborhoods. Services that can be efficiently provided to relatively small populations, say 20,000 residents or fewer, located within a relatively tight geographical area are candidates for BIDs or NIDs. K–12 education, neighborhood police patrols and fire protection, trash collection, street and sidewalk maintenance, parks and recreation, and libraries are examples. Services should be financed solely by the property owners within the BID or NID, and all owners within the district should be required to contribute to the cost of service provision. Within a NID, residents should pay for services by a residential property tax assessed as a supplement to the citywide property or residential income tax. Within a BID, businesses should pay for services by user fees or a piggybacked property—ideally, land—tax.

The level of services in a BID and a NID should be decided by a board elected by property owners. In theory, voting rights should be proportional to the market value of land held by each citizen or firm. Such a rule best aligns individual voter interests with the overall interest of the BID or NID.[21] This voting rule will likely survive court review for a BID but will violate the Supreme Court's requirement of one person–one vote for residential services and thus is likely to be disallowed for a NID. If so, the boundaries for the NID should be drawn to ensure a coincident of economic interests for residents, say by setting NID boundaries to ensure common home values within the district.[22]

Beyond motivating more efficient service provision within their own districts, NIDs and BIDs may provide additional efficiency benefits for the wider city economy. Successful BIDs and NIDs will demonstrate to firms and residents in other city neighborhoods how public services might be more efficiently financed and provided. Successful strategies can then be demanded by residents of other city neighborhoods and replicated there. Through BIDs and NIDs, the efficiency

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20. Briffault (1999) is an excellent survey of the use of BIDs. Robert Ellickson (1998) was one of the first to champion the use of NIDs.

21. And the rule follows the arguments for efficient voting for corporate policymaking; see Harris and Raviv (1988).

22. The argument here parallels that by Bruce Hamilton (1975) for the use of zoning to ensure efficiency in the provision of public services with property taxation.

gains from fiscal competition enjoyed by suburban residents can realized by city residents as well.[23]

What About Fiscal Equity?

Striving for more efficient city finances does not require sacrificing a concern for fiscal equity. But cities cannot achieve fairness on their own. A city government that seeks, or is mandated, to redistribute income or city services beyond what the city's taxpayers desire will drive out less sympathetic residents and profit-maximizing firms, undermine city production and consumption agglomeration and thus city efficiency, and reduce city property values. Like any broadly shared public good, achieving fiscal equity must be a shared responsibility. Even so, there are fiscal policies mayors can pursue to help a city's lower-income residents.

Cities with efficient city governments have more resources than their less-efficient rivals; there are rents. These extra economic resources can be allocated to improve the current and future economic prospects of lower-income families, particularly young children in poverty. Prenatal care, home visits by a registered nurse following the birth of the child, and preschool programs with a strong emphasis on school readiness have all been shown to be effective in preparing lower-income children for K–5 schooling.[24] When lower-income children are ready, they learn more. Their readiness reduces the spillover costs of poverty when providing education to all children. For older children, programs that link schooling directly to job skills through workplace internships show a significant positive impact on future earnings.[25] For adults in eligible families, the city should lower the costs of accessing federal, state, and city poverty programs. Just as efficient cities provide one-stop shopping for firms wishing to locate there, the efficient city should offer similar services to lower-income families applying for state or federally funded poverty assistance. Finally, efficient city finances attract firms into the city, which means greater job access for poor city residents and higher average city wages.

The introduction of NIDs and BIDs as important service providers within the city raises the concern that richer neighborhoods will have the ability to pay for, and now would be able to provide, greater services than their low-income counterparts. This is a valid concern, but not a decisive strike against use of competitive service districts. First, inter-neighborhood equalization aid administered

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23. For evidence that BIDs can be more efficient in the provision of city services, see Brooks (2006). For evidence that such efficiencies can lead to higher property values, see Ellen, Schwartz, and Voicu (2007).

24. Currie (2009) provides an excellent survey of successful programs.

25. Murnane (2009) surveys these programs.

by the city government can be designed to restore the original distribution of city services without undoing the initial gains in fiscal efficiency. For example, the city can ensure a common citywide service minimum while still allowing richer neighborhoods to "top-up" above the minimum. Or the city can allocate revenues directly to approved BIDs and NIDs in lower-income neighborhoods to equalize the ability of all neighborhoods to provide meritorious local services.[26] Further, BIDs and NIDs plus equalization aid add to the economic surplus capitalized into city property values. That surplus can then be taxed to support additional services for lower-income families.

Finally, regional or state cooperation provides a further path to improved fiscal fairness and, if done correctly, fiscally induced efficiencies that might even pay for the added gains in equity. The key will be a beneficial externality that, when correctly priced, generates a social improvement for everyone. Here that externality is the agglomeration economies that arise within our central cities. The mispricing occurs when city residents and firms that provide the gains from agglomeration are asked to pay for a collective interest in fiscal fairness. When taxed to fund poverty services above what they would individually prefer, city households and firms will leave the city for other locations. Agglomeration economies are lost. All who would benefit from those production efficiencies lose, too.

In a study of financing state-mandated poverty services in the Philadelphia metropolitan area, I asked what would happen to city and suburban home values if Philadelphia and the region's suburban counties shared the responsibility for the region's poverty spending, using a proportional tax on all regional residents' incomes. The four suburban counties have 25 percent of the region's poor; Philadelphia has 75 percent. Holding fixed poverty services per poor person at current levels in all counties, but equalizing service financing transferred $191 million annually from suburban residents to the city budget, worth about $125 per Philadelphia resident. Using a general equilibrium model of the Philadelphia metropolitan economy, I found that city home values always rise. But how the money is transferred to the city matters, too. Targeting suburban assistance to be spent totally on cutting the city's nonresident commuter wage tax improved city home values as expected, but lowering a particularly inefficient tax (see table 2.1) improved suburban home values, too. City home values were estimated to rise by 2.1 percent and suburban home values by 1.8 percent (Inman 2003). The higher regional home values could then be used to fund greater services for all lower-income families in the region. Here the efficient provision of fiscal equity has the potential to create a win-win for everyone.

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26. Inman and Rubinfeld (1979) study the equity properties of such programs; Nechyba (1996) studies their efficiency performance.

Conclusions

What guidelines, then, might we offer city officials hoping to achieve efficiency and fairness in the financing of city services? Once we recognize that the primary role of cities is to maximize residents' incomes and well-being and city firms' productivity, our recommendations for city fiscal policy follow directly.

First, cities should provide only those services that residents and firms value and that the private market cannot provide efficiently. This will be city infrastructure—typically, roads and transit, communication networks, justice and prisons, parks, libraries, waste disposal, sewers, and water—and those current services for which there are significant benefit spillovers—K–12 education, police patrols and fire protection, public health, trash removal, and street maintenance. Cities cannot fund significant levels of income redistribution or poverty-related services; firms and middle-class taxpayers that do not value those services for altruistic reasons will leave the city and undermine the city's productive advantages of agglomeration.

Second, cities will need managerial control over labor policies with the full ability to hire and assign workers to tasks as required for the efficient provision of city services. Residential taxes, ideally residential wage taxes and user fees, should be used to finance residential services, and business taxes, ideally a tax on land and user fees, should be used to finance business services. Cross-subsidization of residential services through the taxation of business activity should be avoided. Long-term debt is preferred for financing infrastructure; the temptation to use deficit financing to fund current accounts spending must be resisted. To do otherwise will lead to higher than competitive costs for public services, a tax structure that undermines efficient private-sector choices, and the misalignment over time of service benefits and tax payments. In each instance, a bad public finance decision drives firms and households from the city and damages the long-run efficiency of the private economy.

Third, city officials must have the right incentives for the efficient financing and provision of city services. Elected city officials must have the economic interests of the entire city in mind when setting budgets and the institutional powers to enforce the efficient budget. A strong mayor form of governance with at-large elections has the potential to discipline inefficient, narrow-interest politics, but citizens must be aware of inefficient fiscal choices and be motivated to remove officials who waste their tax dollars. Here market forces can be useful. Waste and misallocations in the public sector translate directly into lower property values as firms and households leave the city. This gives city homeowners a direct stake in efficient city finances. Encouraging the use of competitive service providers within the city through business and neighborhood improvement districts also brings market forces to bear on public service provision. Such districts can efficiently provide most noninfrastructure services. Successful districts will be an option within the city for firms and residents. They may also stand as examples,

for other districts or the city government itself, of how services might be more efficiently provided.

Fourth, while regional or state financing of services to ameliorate city poverty is the preferred alternative, more-efficient city government creates economic surplus value in the private economy that can be taxed (efficiently) and then shared with lower-income households through programs with proven records of success in reducing long-run poverty. Such programs focus on lower-income children and include prenatal health care, new-parent training, preschool readiness, supplemental math and reading, and job-skills-related training. City-funded centers that help low-income adults access federal and state transfer and training programs may be cost-effective, too. In the end, however, city-financed redistribution should not be extended beyond the economic surplus created by private-sector agglomeration.

Reforms along each of these four margins—services, finances, governance, and equity—offer the potential for significant gains in added incomes and profits for city residents and firms. But with any reform, there will be losers as well as winners. Current public employees may lose wages and benefits as the city moves toward more competitive labor contracting. Residents may pay higher taxes as the city's tax burden is reallocated from mobile businesses to fixed structures and resident incomes. Neighborhood services may decline as inefficiently utilized facilities are closed. Middle-class taxpayers, perhaps in the suburbs, may pay higher taxes for services shown to be effective in reducing poverty and its consequences. Yet each fiscal reform proposed here has the potential to enhance private-sector economic performance and increase the value of fixed city land and assets, a value that can be taxed and shared by all who provide and consume city services. Understanding and then finding the private gains of its public choices is the first step to effective reform of any city's finances.

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