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# MUNICIPAL REVENUES AND LAND POLICIES


Edited by Gregory K. Ingram and Yu-Hung Hong

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# CONTENTS

# 5

# *Creative Designs of the Patchwork Quilt of Municipal Finance*

Michael A. Pagano

The municipal budget from the turn of the twentieth century did not have the sophistication of contemporary municipal budgets. Taxes—and at that time, taxes meant only one thing, real and personal property taxes—fines, fees, and anything else were deposited in a single account, and the city council appropriated funds from that account. Simple, elegant, understandable. Modern budgeting during the Progressive era, as reflected in the reform movement's demands for accountability, urged the adoption of line-item budgeting so that administrators could be held accountable to the elected officials (Williams 2004). The emphasis of municipal reformers was on the distribution of the proceeds, not on the revenue. Not until later did citizen and academic concern shift to performance budgeting, or an interest in understanding the value of a dollar of municipal expenditures.

Budgets were simple at that time, often organized by department and funded from a single fund. That single fund, the general fund, was resourced almost entirely from property tax collections. Later in the twentieth century, cities began accounting for funds elsewhere, such as the capital improvement fund, the sinking fund, and the enterprise fund. Yet the municipality's general fund was, and still is, typically the largest fund and supports a city's general operations, including general administration, public safety, and public works, but typically not capital construction activities or enterprise activities.

Between 1902 and today, municipalities have created various funds with several revenue sources and have weaned themselves from near-total reliance on the property tax to fund the costs of delivering services to a more revenue-diverse fiscal regime. Yet the property tax still resonates among the nation's urban citi-

zens as the most important tax source. Even as late as 1977, studies on the tax structure of municipalities began with statements similar to the following: "Since property taxes are the primary source of revenue for municipalities, a comparison of these effective tax rates offers a meaningful insight into the overall tax rate structure of central cities" (MacManus 1977, 278). This is no longer an accurate representation of the own-source revenue portfolio of municipalities, even as it was an exaggeration some 30 years ago.

Over the last century, most cities, certainly the larger cities, have accounted for their revenues and expenditures in multiple funds for utilities, debt retirement, special purposes, capital improvement, and other activities that typically have been tied to a dedicated revenue source. The general fund contains a city's own-source revenues and intergovernmental aid; the capital improvement fund includes borrowed funds in addition to own-source and intergovernmental revenue; enterprise funds typically include fees from an income stream that is derived from the sale of a service, such as water, and can include borrowed funds. Municipalities diversified their funds as they also diversified the revenue portfolios for the purposes of better managing their finances and creating less-volatile revenue structures. As municipal governments accrued greater functions, they adopted more complex fund accounting mechanisms for the purpose of controlling expenditures and making government accountable (Schick 1966).

The challenges of generating adequate resources from municipalities' underlying economic base encouraged, in many cases, policy decisions to expand the breadth and scope of revenues. Exogenous shocks to the stability of municipal fiscal structures in the form of economic crises, such as the stock market crash of 1929, and in the form of political crises, such as the tax revolt of the late 1970s, pressured cities to rethink their access to resources and the sustainability of their revenue structures. The collapse of real estate and financial markets in 2007 and 2008 has presented municipalities with the latest crisis that might alter their fiscal fortunes yet again.

As a result of economic and political shocks to municipal fiscal systems, municipalities' policy actions to shift and shape own-source revenue composition can be grouped into four distinct eras. The first is the pre–Great Depression era, a time in the nation's economic history when ownership of real estate was a fairly accurate indicator of wealth. The second era begins with the economic collapse in 1929 and extends until the end of the Great Society expansion of federal programs, as municipalities diversified their tax base to include retail sales and the federal government intervened in the budgets of cities by providing an unprecedented amount of funding. The third period began with the advent of the tax revolt of the late 1970s, resulting in a sudden decline in the share of property taxes and the dramatic reduction of direct federal aid to cities. The third era ended with the real estate collapse in 2007 and the financial market collapse in 2008. The fourth era that is unfolding at this very moment might be characterized by a change in municipal revenues in response not only to a changing underlying

economy, but also to an emerging new normal. The contours and shape of the municipal revenues during the current era are still unfolding, and opportunities abound for significant and profound changes to municipal revenue structures.

## *Property Tax Reigns: Pre-1930s*

Municipal governments in the United States have long relied on their powers to tax land and structures for the purpose of providing services to their residents. In the nineteenth century personal wealth was measured by the value of property a person held, including not just real estate and structures but personal property as well. As Fisher notes, "In such an [agrarian] economy, wealth and property are the same things and the ownership of property is closely correlated with income or ability to pay taxes" (2002). The preponderance of own-source revenue generated by local governments as well as by state governments was derived from the property tax.

State governments, according to the 1902 census, raised 45 percent of their own-source revenues from the property tax, while the figure for all local governments was 78 percent. While states began to diversify their revenue profiles in the first quarter of the twentieth century—for example, the tax on a gallon of gasoline begun in 1919 in Oregon—municipalities remained dependent on the reliable and stable property tax. As the economic engines of the nation became more entwined with manufacturing and the nation's settlement patterns became more urban, state governments diversified their revenue structures and gradually released control over the state portion of the real estate tax. By the time the stock market crashed in 1929, the state property tax contributed only 15 percent of state funds, and by the post–World War II era, it had dropped to under 3 percent. In exchange for reducing, then nearly eliminating, access to the property tax for state government services, states gave more control over the property tax to local governments. Although municipal governments, in particular, had begun deriving revenue from non-general tax sources, the preponderance of own-source revenue was derived from a tax on real and personal property.

## *The Great Depression and Revenue Diversification: 1930s to Late 1970s*

States began diversifying their revenue sources in the 1930s, essentially ceding the property tax to local governments. During this period, many cities began collecting a tax on retail sales and also expanded the use of enterprise funds for income-producing activities, such as water, thereby increasing fee collections. Toward the end of this period, federal aid became a large part of municipal finances.

### SALES TAX

Revenue diversification, that is, diversifying away from near-total reliance on the property tax, began to gain traction in the 1930s as municipalities began adopt-

ing (or were allowed to adopt) a local option sales tax. The principal reason for diversifying the municipal revenue structure might be thought of as a financial survival strategy. The Advisory Commission on Intergovernmental Relations (ACIR) offered this perspective: "Land values and income from real property fell far more rapidly than did property taxes, and foreclosures to pay property taxes were increasingly common" (1989, 1). Between 1930 and 1939, there were 4,770 municipal defaults. At that time, few municipalities had the legal authority to impose and collect a retail sales tax or to broaden their tax base beyond the property tax. New York City enacted the first sales tax in 1934, followed by New Orleans in 1936 (Due and Mikesell 1995, 277). With the gradual adoption of sales taxes during the 1930s and 1940s by cities given the authority to levy them, or cities assuming the power to tax retail sales as a home rule power, sales tax as a proportion of cities' general revenue reached around 11 to 12 percent of own-source revenues by the 1960s, while the property tax declined in relative significance from 71 to 78 percent in the 1930s to around 50 percent in the 1960s (Kaufman 2004).

Among the early adopters were the municipalities of California and Illinois, which were granted access to the sales tax in the 1940s. By 1962, 12 states had authorized sales tax access to local governments. The grant of authority by Illinois was then extended in the Illinois constitution, enacted in 1970, that proclaimed that the authority to levy a retail sales tax was a home rule power: "Except as limited by this Section, a home rule unit may exercise any power and perform any function pertaining to its government and affairs including, but not limited to, the power to regulate for the protection of the public health, safety, morals and welfare; to license; to tax; and to incur debt" (article VII, section 6a).

While states were authorizing local government access to the sales tax, there was considerable variation in the reliance of municipalities on the property tax. Cities were diversifying their revenue portfolios, as table 5.1 demonstrates. By the late 1970s, sales tax revenues had reached nearly 16 percent of own-source revenues, where it has remained since then. Property tax revenues, as a percentage of own-source revenues, fell sharply from over three-fourths in 1942, to less than one-third in 1972, to between 29 and 32 percent since 1982. As a percentage of total revenue (including utilities and the like), property tax revenue has hovered around 17 percent since 1982, after having been reduced from over half of municipalities' total revenue at the beginning of the era. Access to ad valorem tax revenue varied by state during this era, as it does today. A 1962 study on Oklahoma municipalities noted the intrusiveness of the state's regulatory impact even on home rule cities, resulting in those cities having little access to the ad valorem tax except for debt retirement purposes (Scheffer 1962), a legacy that continues to this day. Oklahoma's municipalities continue to be highly dependent on the sales tax as the main general revenue source for their basic operations. For example, over half of Tulsa's revenues for general fund activities in 2008 are derived from the sales tax, and no property tax revenues are deposited in the general fund (City of Tulsa 2008).

**Table 5.1**
Revenues as a Percentage of Total Revenue

| Year | Total (I+II+III+ IV+V) | General Revenue (I+II+III) | I Total Taxes | Ia Property Tax | Ib Sales Tax | Ic Income, License, and Other | Ic(i) Income | Ic(ii) License and Other | II Charges and Other/ Miscellaneous | III Inter-governmental |
|---|---|---|---|---|---|---|---|---|---|---|
| 1942 | 100.0 | 79.0 | 57.9 | 51.1 | 2.6 | 4.1 | | | 7.4 | 13.8 |
| 1952 | 100.0 | 76.7 | 50.5 | 38.0 | 7.2 | 5.3 | | | 11.5 | 14.6 |
| 1957 | 100.0 | 77.1 | 49.0 | 35.7 | 7.8 | 5.6 | | | 13.5 | 14.6 |
| 1962 | 100.0 | 78.2 | 47.2 | 34.6 | 7.8 | 4.9 | | | 15.0 | 15.9 |
| 1967 | 100.0 | 80.0 | 43.6 | 30.5 | 6.8 | 6.3 | | | 15.3 | 21.1 |
| 1972 | 100.0 | 82.8 | 40.4 | 26.0 | 7.5 | 6.8 | | | 15.3 | 27.1 |
| 1977 | 100.0 | 82.5 | 35.4 | 21.3 | 7.9 | 6.3 | 4.2 | 2.1 | 14.4 | 32.7 |
| 1982 | 100.0 | 79.0 | 32.1 | 16.9 | 8.8 | 6.4 | 4.3 | 2.1 | 19.5 | 27.4 |
| 1987 | 100.0 | 76.7 | 32.7 | 16.0 | 9.2 | 7.4 | 4.7 | 2.7 | 21.9 | 22.2 |
| 1992 | 100.0 | 77.8 | 33.9 | 18.0 | 9.0 | 7.0 | 4.5 | 2.4 | 21.9 | 22.0 |
| 1997 | 100.0 | 77.4 | 32.9 | 16.0 | 9.5 | 7.4 | 4.8 | 2.6 | 22.6 | 21.9 |
| 2002 | 100.0 | 84.6 | 35.5 | 17.3 | 10.5 | 7.8 | 4.5 | 3.3 | 23.9 | 25.2 |

Source: U.S. Census Bureau, various years.

## INCOME TAX

It should be mentioned that as the local option sales tax was increasing in popularity and adoption after World War II and especially during the 1960s, a few municipalities were experimenting with an income tax. ACIR notes that "Initial adoptions [of the income tax] took place in response to fiscal pressures: Philadelphia (1938), St. Louis (1948), Cincinnati (1954), Pittsburgh (1954), and Detroit (1962) all adopted local income taxes. There was a wave of adoptions in the late 1960s and the 1970s, again primarily in cities, for the purpose of providing property tax relief, diversifying the local revenue base, and extracting revenue from suburban residents who worked in the central city" (1988, 9). Although these income taxes did benefit the fiscal health of the cities, they constituted a relatively small amount of revenue compared to total municipal budgets nationwide. Nevertheless, for some cities—especially cities in Ohio, New York City, Philadelphia, Detroit, St. Louis, and Kansas City, Missouri—income tax receipts today constitute a large proportion of total revenue. For many Ohio municipalities, for

| IV Utilities and Enterprise | V Insurance and Other | Own-Source Revenues (excluding enterprise funds) as Percentage of Total Revenue (I+II/Total) | Property Tax as Percentage of Own-Source Revenue (Ia/(I+II)) | Sales Tax as Percentage of Own-Source Revenue (Ib/(I+II)) | Charges as Percentage of Own-Source Revenue (II/(I+II)) | Charges Plus Enterprise Funds as Percentage of Total Revenue (II+IV) |
|---|---|---|---|---|---|---|
| 21.0 | | 65.2 | 78.4 | 4.1 | 11.3 | 28.4 |
| 20.8 | 2.5 | 62.1 | 61.2 | 11.6 | 18.6 | 32.3 |
| 20.2 | 2.7 | 62.5 | 57.1 | 12.4 | 21.5 | 33.7 |
| 19.1 | 2.7 | 62.2 | 55.6 | 12.5 | 24.1 | 34.1 |
| 17.2 | 2.8 | 58.9 | 51.8 | 11.6 | 26.0 | 32.5 |
| 14.4 | 2.8 | 55.7 | 46.8 | 13.6 | 27.4 | 29.7 |
| 14.8 | 2.7 | 49.8 | 42.7 | 15.8 | 28.8 | 29.2 |
| 18.0 | 3.0 | 51.6 | 32.7 | 17.1 | 37.8 | 37.5 |
| 17.1 | 6.2 | 54.5 | 29.4 | 16.9 | 40.1 | 39.0 |
| 16.0 | 6.2 | 55.8 | 32.2 | 16.1 | 39.2 | 37.9 |
| 15.2 | 7.4 | 55.5 | 28.9 | 17.1 | 40.8 | 37.8 |
| 16.3 | –1.0 | 59.4 | 29.1 | 17.7 | 40.2 | 40.2 |

example, the income tax amounts to 60 to 70 percent of own-source revenues. Columbus generates 60 percent of its general fund revenues from the income tax and 7 percent from the property tax (City of Columbus 2008).

## FEES

At the same time, municipalities—confronted with the damaging fiscal effects of the Great Depression and hundreds of thousands of defaults on bonds—began searching in earnest for ways to apportion costs to users of certain services. In 1935 the nation's first parking meter was implemented in Oklahoma City. By that time, the technology had advanced enough that it was cost-effective to purchase the technology (the meter) and to charge customers for the use of the city's parking space. Another technological advancement, the water meter, began being installed in the late 1800s, and cities were then able to remove (or at least reduce) the costs of some departments or activities from competing with other worthwhile projects in search of general fund revenue (primarily property tax revenue).

Municipalities and other governments began establishing separate funds to account for the revenue stream that utilities and other enterprises generated. As technological innovations were developed to measure individual consumption, municipalities could account for the revenue stream from such services and place those revenues in enterprise funds. These funds were established to collect fees based on the pricing philosophy that the fee structure should resemble a market structure, measuring demand and setting rates to match marginal costs. Enterprise funds were established to reduce cross-function subsidies and to encourage self-financing of the enterprise. Table 5.2 indicates that constant-dollar property tax revenue per capita for municipalities (measured as property tax receipts divided by urban population, which is an admittedly crude measure) declined by 45 percent during this era, from $456 per capita in 1942 to $255 in 1977, while constant-dollar user fees (including enterprise funds) increased from $252 to $349, a 38 percent increase, or approximately 3.9 percent per annum, which pales compared with the 6.5 percent per annum growth rate between 1977 and 2002.

Although the adoption and expansion of user fees during this period helped to reduce budgetary stress on other city services for which fees were not appropriate, user fees' popularity is due also to their implementation. That is, a characteristic of a user charge is that it is a market-like pricing mechanism that gauges consumer preference or demand and has the possible effect of encouraging production and consumption efficiency. For goods to which a fee can be attached, it also is equitable in that nonconsumers do not pay for the service. Of course, a fee for basic services, such as water, can exclude the poor from consuming water, but many cities have been careful to provide assistance through subsidies and discounts. The rationale, then, in support of the adoption or extension of user fees is that an increase in fees is an understandable market price action and generates less taxpayer (fee-payer) hostility than a tax increase and that it tends not to be subject to tax limitations, thereby making it more accessible.

## FEDERAL GOVERNMENT

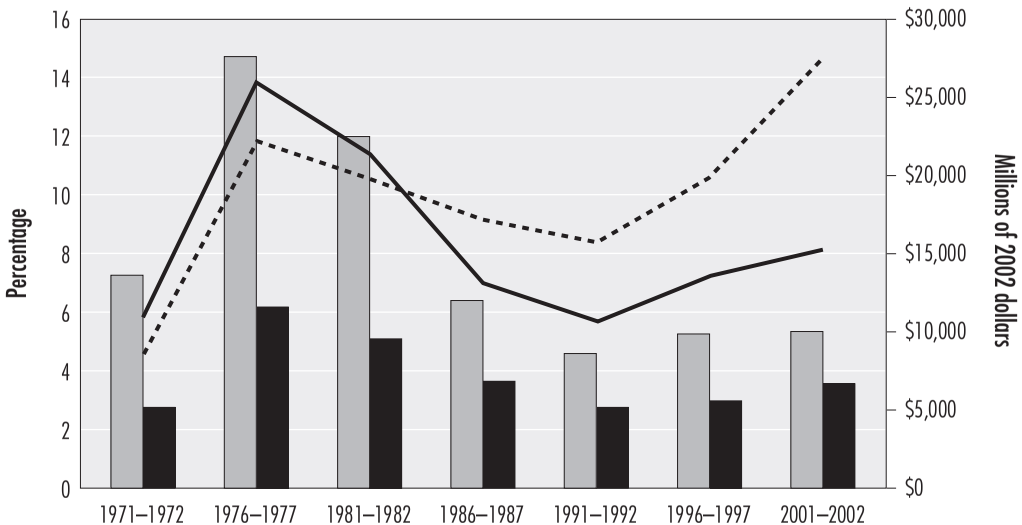
By the late 1960s the federal government's concerns for the fiscal welfare of cities heightened. Creation of the State and Local Fiscal Assistance Act (general revenue sharing) in 1972, followed by the Community Development Block Grant in 1974 and a series of stimulus plans (e.g., Local Public Works Acts I and II, Anti-Recessionary Fiscal Assistance, Comprehensive Employment and Training Act) provided municipalities with both strong financial ties to Washington and increasingly powerful regulatory clamps. As figure 5.1 illustrates, federal aid to municipalities reached $25 billion (in constant dollars) in fiscal year 1978, amounting to nearly 15 percent of general municipal revenue. This high-water mark coincided with the federal government's ambitious attempts to restore vitality and order to America's cities, as embodied in *The President's National Urban Policy Report of 1978* (U.S. Department of Housing and Urban Development 1978). Within a year of the report's release, the mood in Washington

**Table 5.2**
Real per Capita Revenue (Base Year = 2000)

| Year | Urban Population (thousands) | Total | General Revenue | I Total Taxes | 1a Property Tax | 1b Sales Tax | Ic Income, License, and Other | Ic(i) Income | Ic(ii) License and Other | II Charges and Other/ Miscellaneous | III Inter-governmental | IV Utilities and Enterprise Funds | V Insurance/ Other | Own-Source Revenues (excluding enterprise funds) | Charges Plus Utilities |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 1942 | 76,059 | 892 | 705 | 516 | 456 | 23 | 36 | | | 65 | 123 | 187 | n.a. | 582 | 252 |
| 1952 | 100,092 | 693 | 531 | 350 | 263 | 50 | 36 | | | 80 | 101 | 143 | 17 | 430 | 223 |
| 1957 | 109,560 | 786 | 605 | 385 | 280 | 60 | 44 | | | 105 | 114 | 159 | 21 | 491 | 264 |
| 1962 | 129,854 | 830 | 649 | 392 | 287 | 64 | 40 | | | 124 | 132 | 158 | 22 | 517 | 282 |
| 1967 | 138,022 | 944 | 755 | 411 | 288 | 64 | 59 | | | 144 | 199 | 162 | 26 | 556 | 306 |
| 1972 | 154,033 | 1073 | 888 | 433 | 279 | 81 | 73 | | | 163 | 290 | 154 | 29 | 598 | 317 |
| 1977 | 161,743 | 1200 | 990 | 425 | 255 | 94 | 75 | 50 | 24 | 172 | 392 | 177 | 32 | 597 | 349 |
| 1982 | 170,736 | 1183 | 935 | 380 | 200 | 104 | 75 | 50 | 24 | 231 | 324 | 212 | 35 | 611 | 443 |
| 1987 | 178,567 | 1373 | 1053 | 448 | 220 | 126 | 102 | 65 | 37 | 300 | 304 | 234 | 84 | 749 | 534 |
| 1992 | 192,899 | 1434 | 1116 | 487 | 257 | 129 | 100 | 65 | 34 | 314 | 315 | 229 | 89 | 801 | 543 |
| 1997 | 205,031 | 1531 | 1185 | 503 | 245 | 145 | 112 | 73 | 39 | 346 | 335 | 232 | 112 | 850 | 578 |
| 2002 | 227,812 | 1406 | 1190 | 499 | 242 | 147 | 109 | 63 | 45 | 335 | 355 | 229 | –13 | 836 | 564 |

Note: Data for 1947 are unavailable.
Source: U.S. Census Bureau, various years.

**Figure 5.1**
Federal Aid to Municipalities and Other Local Governments




| | 1971–1972 | 1976–1977 | 1981–1982 | 1986–1987 | 1991–1992 | 1996–1997 | 2001–2002 |
|---|---|---|---|---|---|---|---|
| Federal aid as percentage of general municipal revenue | 7.3% | 14.7% | 12.0% | 6.4% | 4.6% | 5.3% | 5.3% |
| Federal aid as percentage of total local government revenue, excluding municipalities | 2.8% | 6.2% | 5.1% | 3.7% | 2.8% | 3.0% | 3.6% |
| Federal aid to municipalities ($millions) | $10,874 | $25,867 | $21,246 | $13,076 | $10,618 | $13,614 | $15,201 |
| Federal aid to local governments, excluding municipalities ($millions) | $8,625 | $22,191 | $19,824 | $17,152 | $15,729 | $19,863 | $27,750 |

Source: U.S. Census Bureau, various years.

changed. The Carter administration backed away from further financial entanglements with cities, and the election of Ronald Reagan in 1980 began a rapid de-escalation in direct federal aid. By fiscal year 1987, federal aid to municipalities had retreated to 6.4 percent of general municipal revenue and amounted to half the constant-dollar value it had reached just 10 years earlier. Cities' revenues since the shock of the tax revolt in 1978 stabilized around 1987 at 73–22–5, meaning that 73 percent of municipalities' total revenues are derived from own-source revenue, 22 percent from state aid, and 5 percent from federal aid, a level that has remained fairly stable for 20 years.

## *Tax Revolt and Federal Withdrawal: 1978–2009*

The political shock of the tax revolt (especially California's Proposition 13) encouraged a major realignment of own-source revenue structures as both the level of expenditures and the tax burden were attacked. The most notable statistics from this era are (1) the dramatic decline in property tax revenue as a percentage of municipal revenue, falling from 41 percent to 31 percent of own-source revenues; (2) the absolute decline in federal aid; and (3) the escalation of user fees from 30 percent to 40 percent of own-source revenues between 1978 and 1982. The political shock of Proposition 13 and the tax revolt dampened the enthusiasm for property tax increases. Cities searched for services that could easily be supported by charging fees for use; tax and spending limitations forced this innovative behavior, which also spurred the creation of more enterprise-funded activities. At the same time, the federal government was realigning its relationship with state and local governments as a result of the Reagan philosophy of sorting out roles and responsibilities of the federal system.[1] User fees increased as a proportion of own-source revenues; direct federal aid to municipalities declined.

### FEES REDUX

The importance of government-imposed user charges and fees to financing public services is well documented (Downing 1992; Hoene 2004), as are the fees charged by homeowners associations for the provision of government-like services such as garbage pickup and street sweeping (McKenzie 1994). The Advisory Commission on Intergovernmental Relations noted that "benefit-based taxes and user charges provide a logical way for policymakers to reconcile the need for more revenue with the realities of voter resistance to state and local taxes, particularly the property tax" (1987, 1). As technology has improved governments' capacities to measure public service consumption and as the tax revolts of the past 25 years have encouraged efficient service production via the market-like

1. The level and degree of federal regulation on state and local governments, however, had the effect of driving up the costs of government. As federal aid dwindled, then, federal intervention increased through partial preemptions and mandates. See, e.g., ACIR (1992).

user fee, governments have identified scores of possible applications of fees. A Government Finance Officers Association catalog of user fees and charges listed over 1,500 separate fees, ranging from the familiar (water and sewer fees, airline landing fees, and yard waste fees) to the obscure ("messenger fee" imposed by Indianapolis when a staff member "must travel to a patron's home to retrieve overdue library material"), used by 178 governments (Strachota and Engelbrekt 1992). Even common functions such as emergency medical services can be billed to the user, as the city of Winter Haven, Florida, has done recently by implementing an "accident response fee" (Lemov 2009).

In a study that crosses the two municipal fiscal eras reported in this chapter, Netzer found that local governments (including municipalities) increased their reliance on user charge revenue from 1962 through 1989 (Netzer 1992). Recognizing the difficulty in accurately measuring user fee reliance, Netzer created a narrow and a broad definition of local government reliance. The narrow definition included current charges and utility revenues; the broad definition added highway user taxes, special assessments, and fines. In 1962 the narrow definition of user fees amounted to 26.4 percent of local government own-source revenues (defined as own-source general revenue plus utility revenue); in 1972 these user fees were a slightly smaller 25.6 percent; and in 1982 and 1989, they became slightly more than one-third of own-source and utility revenues (33.4 percent and 33.7 percent, respectively). Census data on the municipal sector as reported in table 5.1 find a similar trend. Reliance on user fees including enterprise (utility) funds, although not highway user fees, amounted to approximately 24 to 27 percent of municipal general revenue between 1962 and 1982. By 1987 fees and enterprise funds reached approximately 38 percent, a position that has remained fairly stable since then.

Another study found that between 1989 and 1999, a select sample of 124 cities had increased the aggregate number of enterprise funds from 491 to 551, a 12 percent increase in a decade (Bunch 2000, 20). The increase in enterprise fund usage might be attributable to the greater feasibility of raising fee rates than of raising tax rates, or to an increased interest in privatization, or to federal mandates (especially in the environmental arena). The average annual growth rate in these cities' enterprise fund revenues exceeded the growth rate in their general fund revenues, usually by a substantial margin. This represents a transfer of general fund activities (tax supported) to enterprise funds (fee supported), or to the kind of activity that tends to be accounted for in an enterprise fund (namely, one that has a higher demand function associated with it).

During this era, the fiscal imperative for cities has been to hold down taxes and search for services to which fees might be attached. Although the growth in user fee reliance appears to be part of a national pattern resulting from the pressures to hold down the tax burden, studies on whether cities are reliant on one general tax source compared to another have not been conducted. Those activities that are conducive to full fee funding (e.g., water, sewer) have moved toward enterprise funds, requiring (or at least encouraging) no subsidies from the

municipalities. Such enterprise activities are expected to be fully funded, which in turn has encouraged cities to set fee structures at a level that ensures self-sufficiency. As tables 5.1 and 5.2 demonstrate, fees and enterprise revenues now constitute the major single source of own-source revenue for municipalities. In 1977 total fees and charges, including fees for enterprise-related services, jumped from $349 per capita to $546 per capita (constant dollars) in 2002, an average annual increase of 6.5 percent. General taxes during this same period grew at a 3.4 percent annual rate.

## DIVERSITY

Clearly, municipalities have become increasingly less reliant on the property tax (and even the contribution of sales tax revenues to own-source revenues has remained fairly stable at around 15 to 17 percent for the last 30 years) and more reliant on user fees. Yet today, nearly 75 years after cities began experimenting with taxing retail sales and income and some 30 years after the tax revolt accelerated the preponderance of user fees and charges as a percentage of municipal own-source revenues, it is disingenuous to speak of a typical revenue structure for the nation's municipalities. Diverse revenue portfolios—as opposed to single-source revenue systems—are a preferred fiscal choice of academicians (Hendrick 2004; Ladd and Yinger 1989; Suyderhoud 1994). A more diverse revenue portfolio better positions a municipality to weather economic downturns and to adapt to changing economic bases. Sales and income tax receipts tend to reflect immediate shifts in the underlying economic base and are also elastic with respect to income (the elasticity for the sales tax is approximately 1, and for the income tax it is estimated to be greater than 1). Property tax receipts tend not to react as quickly to underlying shifts in the economic base and are considered a more stable and less volatile revenue source (Fisher 1996). The admixture of these general taxes, then, provides some stability and some responsiveness to changes in cities' economic bases, much like individuals' diversified revenue portfolios.

Municipal tax and revenue authority varies greatly, depending on state law. Some states authorize cities to levy only local property taxes, which is common in many of the northeastern states. Some cities in Arizona can impose a municipal property tax only after an affirmative vote of the electorate. (Mesa, with some 400,000 residents, was the largest U.S. city without a property tax. In 2009, the city of Mesa voted in the property tax.) Some states authorize the use of local property and sales taxes, which is fairly common in western and southern states. Other states, such as Ohio, Kentucky, and Michigan (for approximately 23 cities), allow a local income tax in combination with property or sales tax authority. In some cases, local income taxes are also authorized for individual cities, usually larger cities such as New York City, St. Louis, and Kansas City, Missouri (Hoene and Pagano 2009). While access to the property tax by municipalities is nearly ubiquitous, their revenue structures are anything but homogeneous. For example, of the approximately 555 U.S. cities with populations greater than 50,000, roughly 34 percent have access to the property tax only, 8 percent have access to

the income tax (in addition to having access to the property tax), and nearly 58 percent have some retail sales taxing authority.[2]

Figure 5.2 illustrates the variation in access to general taxes by state. The map is a visual representation of the variegated taxing authority of cities by state. It demonstrates that the last several decades have created reliance on just one tax source for cities in some states, while others rely on all three general tax revenues. *Reliance* for the purposes of this map is defined as 1 standard deviation above the mean for a single tax source (percentage share of general revenue; see Hoene and Pagano 2009). As a consequence of this continuously evolving municipal revenue structure, it is no longer useful or descriptive to speak about the revenue structure of the average city. The property tax city of the pre–Great Depression era is no longer the model for cities today.

## *The Future: 2009 and Beyond*

Although there is a clear trajectory of municipal revenue structures from near-total reliance on the property tax until the Great Depression, to a more diversified tax portfolio through the 1970s, to a fee/charge/other-reliance in the post-1978 era, whether the nation's municipalities are at the doorstep of yet another era is difficult to predict. As the former New York Yankees manager and sometime worldly philosopher Yogi Berra remarked, "It's tough to make predictions, especially about the future." The current economic and fiscal crisis adds a dimension of complexity that has analysts now talking about the new normal. The new normal for metropolitan regions will arise from the fiscal crises cities are now confronting, and will not resemble the new normal that arose from the ashes of the Great Depression.[3] In the spirit of Stanford economist Paul Romer's sage advice that "a crisis is a terrible thing to waste," following are a few thoughts on the new normal. One thought derives from the sudden economic shock to municipal fiscal systems; the second thought extends from the observation that inter-local cooperation and regional approaches to fiscal policy challenges might allow for a renewed conversation about regionalism.

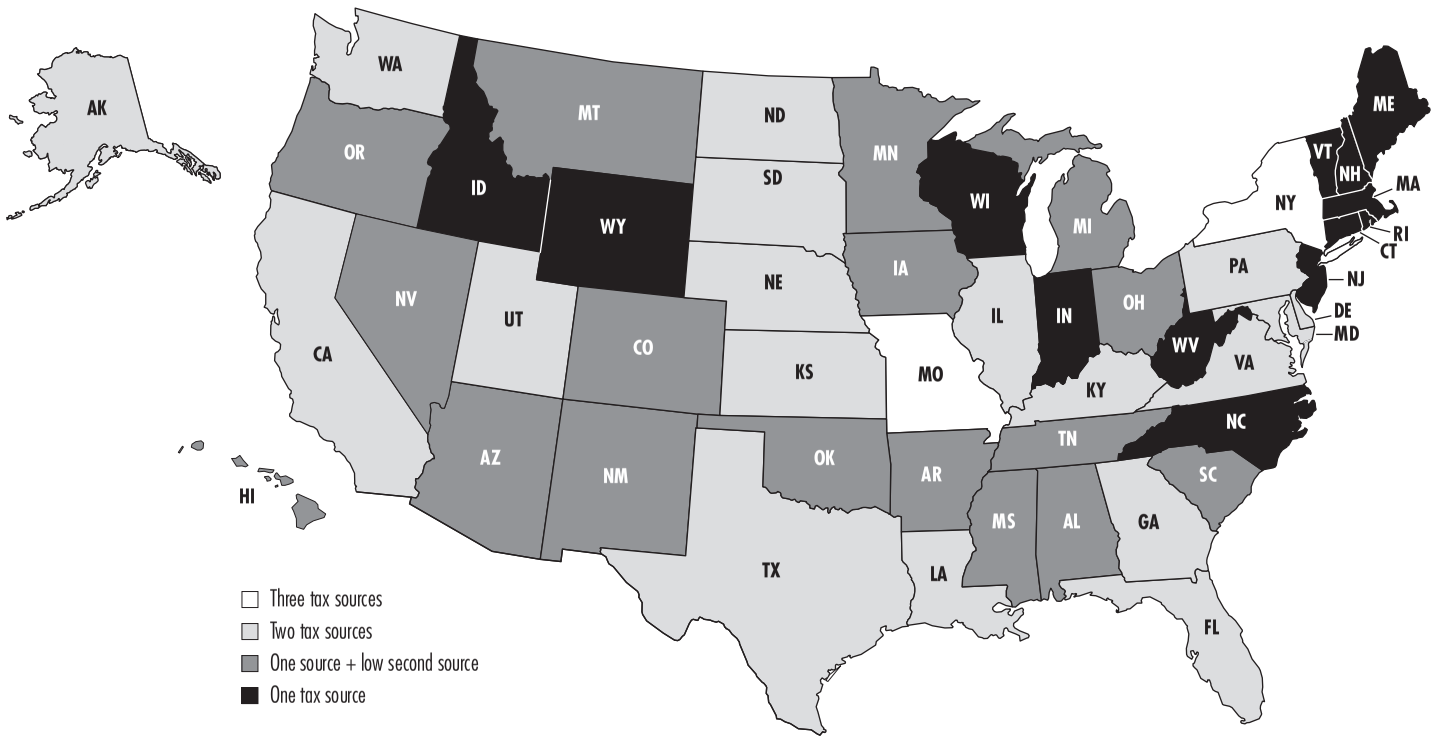
### CURRENT REVENUE MIX OF THE GENERAL FUND

The economic shock wrought by the confluence of a housing bubble burst and a stock market decline has placed cities in the most precarious fiscal position they have been in at least a generation, if not since the Great Depression. A report that monitors the change in cities' general funds documents the deteriorating fiscal position of the largest city fund that supports most cities' basic services. The

2. Calculation by the author. General taxing authority derived from Pagano (1999) and revised by the author. See also Von Ins (2001).

3. For a discussion of the fears that were discussed as the United States pulled out of the Great Depression and the federal government was preparing for war, see Long (1941).

**Figure 5.2**
Municipal Revenue Reliance by State




Sourece: Hoene and Pagano (2009).

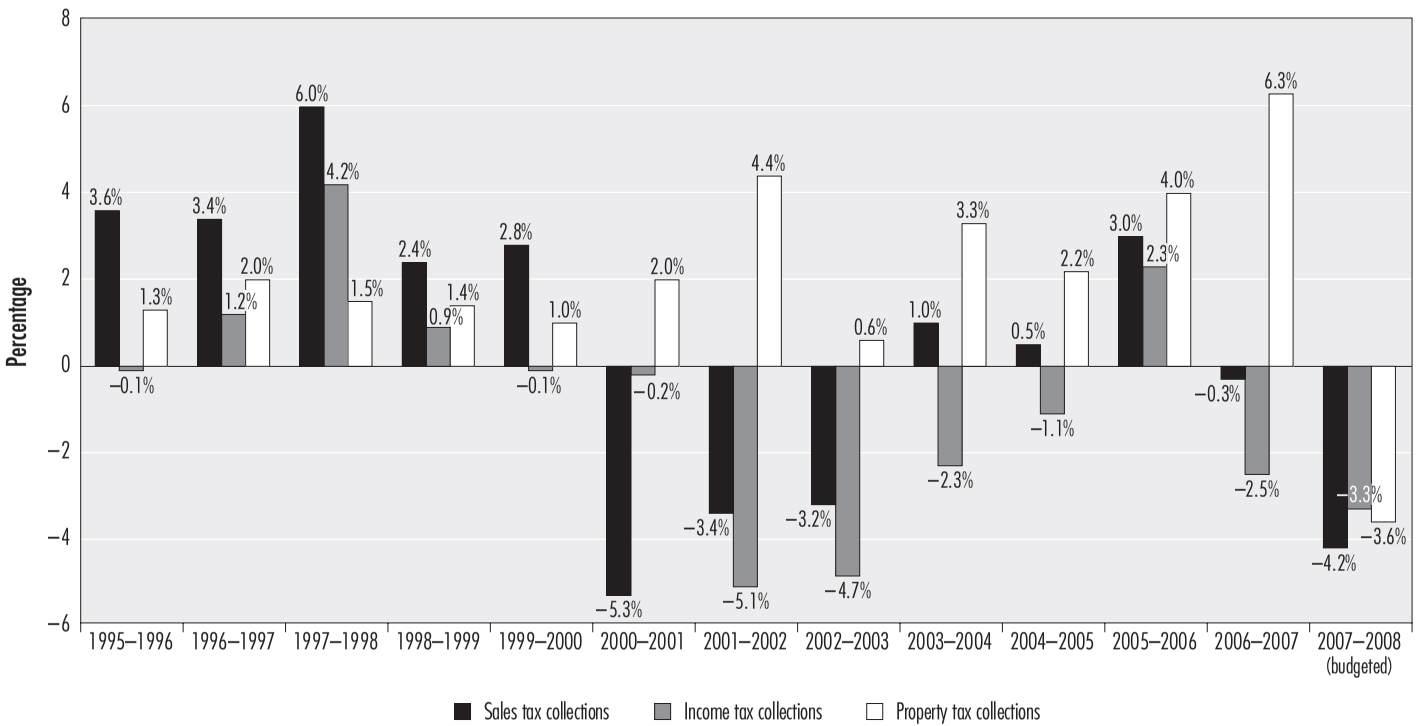
*City Fiscal Conditions* report relies on general fund finance data collected from the chief financial officers of U.S. cities for the current fiscal year and the two prior years. The general fund data in figure 5.3 demonstrates that, by the close of fiscal year 2008, both general fund revenues and spending could be expected to decline in inflation-adjusted terms (Pagano and Hoene 2008).[4] Revenues were predicted to decrease by 4.3 percent and spending by 1.5 percent. The variation in revenue authority around the country usually means variation in the impact of economic downturns—some taxes, and therefore some cities, tend to be more or less affected than others. General fund revenue data, disaggregated by general tax source, demonstrated that all three major sources of general fund tax revenue—property, sales, and income taxes—were expected to decline at the same time. In previous recessions, sales and income tax shifts coincided with the economic cycles due to their elasticity; property tax receipts, because their collections lag by 18 to 24 months, increase and decrease after the trough or peak of the business cycle and thus have a somewhat countercyclical effect. The aggregate effect is that during brief recessions, property tax receipts fall after the economy—and thus sales and income tax receipts—have rebounded. During fiscal year 2008, and presumably fiscal year 2009 (although data have not yet been analyzed), the real estate market collapse that began in 2007 affected property tax receipts just as the nation's economy began reeling from the global downturn.

## NEW NORMAL?

The current economic indicators suggest that retail spending has declined and personal savings have increased over the last year. Should consumers become savers, the impact on retail sales tax collections could be damaging in the long run, assuming no adjustment to the tax base. Moreover, if the recovery does not increase wages and salaries, income tax receipts for municipalities cannot be expected to improve much (of the municipalities with income tax authority, only New York City has the authority to tax capital gains). If real estate values bottom out in late 2009 or 2010, the declining impact on real estate taxes will be felt until at least 2011, if not later, and then the increase, if moderated by less pressure on real estate prices that ran up to the 2007 collapse, might grow only modestly thereafter. In other words, if the new normal in general tax receipts means that sales, income, and property taxes will not grow as robustly as they did together (although not individually), then user fees, because they are likely to remain generally strong (and cities continue to adopt and expand them), will grow as a proportion of own-source revenues if for no other reason than the other own-source elements will not grow. Moreover, user fees for enterprise fund

4. The annual survey is administered to all cities with populations greater than 50,000 and a sample of cities between 10,000 and 50,000. The 2008 survey data are drawn from 319 responding city finance officers, for a response rate of 30.2 percent. The response rate for cities with populations greater than 100,000 was 40 percent (see Pagano and Hoene 2008).

**Figure 5.3**
Year-to-Year Change in General Fund Tax Receipts (constant dollars)




Source: Pagano and Hoene (2008, 4).

activities are more likely to be responsive to demand (and, therefore, to possibly increase over time) because enterprise funds are required to be self-sufficient. If so, then fees and charges as a percentage of total municipal revenue (inclusive of enterprise fund activities) will most likely rise.

If all three general tax sources remain fairly stable over at least the medium term, cities may find themselves in a position unlike any they've ever seen, but one that might allow a fundamental political reshaping of the fiscal landscape. If the economic shock of the Great Depression pushed states to reconsider their fiscal relationship with cities and, in many cases, to grant access to revenue sources that were previously proscribed, the current recession might do something similar. That is, cities now have a political opening to explore with their states the opportunity to design a fiscal system that matches their economic base, such as broadening the sales tax base or accessing an income tax. As cities should be trying to design systems to secure their individual fiscal health, they are simultaneously worried about their broader metropolitan areas. Cities have learned over the past few years that they're all in it together. The era of the new normal might be marked by conversations about regional tax sharing, regional services, and regional governance (Altshuler et al. 1999; Orfield 1997; Rusk 1995, 1998).

## REGIONAL TAX?

Probably the most celebrated case of a regional tax was initiated in 1968 by the Citizens League in the Twin Cities area (Minneapolis and St. Paul, Minnesota) and voted into law by the legislature in 1971. According to the Metropolitan Fiscal Disparities Act, each year local governments in a seven-county area calculate changes in assessed value of industrial-commercial property and contribute 40 percent of the growth to an area-wide pool. Each government receives funds from this pool according to a formula that takes into consideration the community's population and is inversely related to its fiscal capacity, defined as per capita market value of all real property—that is, larger cities with lower fiscal capacity receive more funds (Bell 1994; Chernick and Reschovsky 1995; Nunn and Rosentraub 1996; Reschovsky 1980).

In Montgomery County, Ohio, a voluntary tax-sharing program was created in 1989 for the purpose of pooling resources for economic development programs and for promoting government equity. The program, the Economic Development/Government Equity program (ED/GE), requires a 10-year commitment from participating municipal, village, and township governments, which are then eligible to apply for economic development funds. The government equity part of the program is funded from tax-base sharing. The economic development funds come from a one-half-cent county sales tax. The complex and politically contentious formula for the tax-base sharing pool limits any one local government's contribution to 13 percent of its tax revenues, and the distribution of the pool is based on population (Nunn and Rosentraub 1996; Pammer and Dustin 1993).

Although property tax-base sharing among municipalities has received considerable attention as a policy option to promote a regional system of public

finance, less visible among policy options is the commuter tax, which serves a similar purpose; namely, it taxes nonresident users of a city's services. One evaluation of property tax-sharing schemes concluded that the benefits of shared property taxes would be relatively small and that "the most effective ways to reduce central city fiscal strains are shifting from local property tax financing to personal income tax financing at the regional and especially at the state level" (Gilbert 1979, 688).

## A DIGRESSION

Only two states (Ohio and Kentucky) allow all their municipalities to impose a uniform income tax rate on both residents and nonresidents. For cities in those two states, the municipal income tax is essentially both a commuter tax and a tax-base sharing tax. In the Ohio case, municipalities can impose a 1 percent municipal income tax (MIT) by a vote of the city council and can increase the tax by a vote of the electorate. Nearly all of the state's 241 cities and 310 (45 percent) of its villages have adopted the MIT.[5] Ohio's MIT is a tax on earnings, including all salaries, wages, and compensation earned within the taxing jurisdiction and earned by residents of a municipality who work elsewhere, making it the most widespread use of a commuter tax in the nation. It is not a tax on wealth more broadly defined and, therefore, does not tax capital gains, welfare benefits, intangible property, unemployment insurance benefits, Social Security benefits, and qualified retirement plans. The MIT is also a tax on businesses' net profits. Given the possibility that individuals can be taxed by two (or more) municipalities, the city of one's residence may opt to forgive a portion of the individual's tax liability to the city of employment, a policy called a tax credit. Approximately two-thirds of Ohio's municipalities grant this tax credit, averaging 82 percent of an individual's tax liability to the city of residence.

Since 1946 Ohio municipalities have levied an MIT, predating state legislation specifically authorizing this power. Toledo was the first Ohio municipality to pass an income tax ordinance, followed in 1949 by Columbus, Dayton, and Youngstown. In *Angell v. Toledo* (153 Ohio St. 179 1950), the Ohio Supreme Court upheld Toledo's municipal income tax as a constitutional application of its home rule powers. Additionally, the court clarified the right of all Ohio municipalities to tax nonresident workers, subject to the Ohio General Assembly's constitutional prerogative to limit that authority. Ohio municipalities also may adopt a tax credit, a partial tax credit, or piggyback tax rules for their residents who pay municipal taxes to the municipality of their place of employment. The Ohio court has also stated that municipalities may require withholding of employees' taxes by employers (Schmarr and Spretnak 2000).

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5. The distinction between villages and cities is denoted by a population threshold. Villages are municipal corporations with fewer than 5,000 residents.

By 1957, 27 Ohio municipalities had adopted an income tax ordinance, and many others were considering adoption. Municipal income tax ordinances varied greatly in their definition of the income tax rate, tax credit, and definitions of taxable income. Consequently, the Ohio General Assembly passed legislation in 1957 to provide greater uniformity among municipalities' income tax provisions. Section 718 of the Ohio Revised Code requires that a municipal income tax be levied at a uniform rate and that the municipality's electorate vote on any tax rate increase in excess of 1 percent. This section remains the state's primary statutory guideline over municipalities' income tax policies. By the time the state decided to impose its own income tax in 1971, more than 300 municipalities had adopted the MIT.

Ohio municipalities rely heavily on the MIT and to a minor extent on the property tax. On average, Ohio municipalities received 46.2 percent of their own-source revenue from the income tax and only 11.4 percent from the property tax (37.8 percent is from fees and charges), according to 2002 census data; the income tax share has decreased over the last decade because income tax receipts increased at a much slower rate than other own-source revenues. The extent of tax exporting or tax-base sharing among municipalities in Ohio is not known. The state does not require municipalities to report the source of municipal income tax revenue. To examine the tax-base sharing implications of the MIT, data were collected from individual cities and regional tax administrators (Pagano and Forgette 2002).[6]

Data from a sample of municipalities in northeast Ohio are particularly revealing of the extent of tax-base sharing, ranging from the $210 million net subsidy to Cleveland[7] (amounting to roughly two-thirds of the city's total MIT collections) to the net loss of nearly $1 million in MIT revenue to the bedroom community of Munroe Falls (a community of 8,500 persons located four miles northeast of Akron). Table 5.3 presents a sample of each city's tax exporting in terms of percentage of total MIT collections and in actual dollar amounts. The net beneficiaries of the tax are the employment centers of the region, that is,

6. A questionnaire was distributed to municipalities via the Ohio Municipal League Web site in December 2001. Each city's income tax administrator (or the regional tax administrator for cities that pooled their tax collection efforts) was asked to estimate the proportion of the total income tax collection that was derived from each of the following sources: (1) earnings of residents who worked in the city; (2) earnings of nonresidents who worked in the city; (3) earnings of residents who worked outside the city; and (4) earnings of businesses. Thirty-nine of the 53 responding cities were from the Cleveland-Akron consolidated metropolitan statistical area (CMSA), where they constituted 26.5 percent of the municipalities in the CMSA. Only 125 of the 133 municipalities in the Cleveland-Akron CMSA required mandatory filing of income tax forms. The realistic response rate, then, is closer to 31.2 percent. The combined population of 1,065,279 in the 39 cities represents 43.7 percent of the region's population.

7. Net subsidy is defined as the nonresident MIT contribution less forgone MIT revenue from residents who work in another city.

**Table 5.3**
Net Tax Exporting, 2000

| City Name | Municipal Income Tax Revenue ($) | Net Exporting (% of MIT) | Tax Exporting ($) |
|---|---|---|---|
| Cleveland | 319,082,000 | 66.06 | 210,801,098 |
| Akron | 93,689,000 | 44.83 | 41,997,000 |
| Brook Park | 19,657,000 | 83.27 | 16,376,900 |
| Mentor | 28,302,000 | 40.75 | 11,532,510 |
| Euclid | 29,174,000 | 39.36 | 11,484,068 |
| Youngstown | 33,421,000 | 32.70 | 10,928,667 |
| Willoughby | 14,973,000 | 43.55 | 6,520,993 |
| Warrensville Heights | 8,858,000 | 67.29 | 5,960,767 |
| Painesville | 7,210,000 | 53.90 | 3,886,234 |
| Highland Hills | 2,281,000 | 95.32 | 2,174,283 |
| Medina | 4,730,000 | 44.65 | 2,111,751 |
| Grand River | 325,000 | 66.38 | 215,732 |
| Geneva-on-the-Lake | 142,000 | 5.32 | 7,559 |
| Northfield Village | 686,000 | –18.27 | –125,352 |
| South Russell | 957,000 | –35.63 | –340,982 |
| Gates Mills | 1,481,000 | –23.18 | –343,349 |
| Mentor on the Lake | 701,000 | –83.49 | –585,287 |

Source: Pagano and Forgette (2002).

those with substantially larger daytime populations than nighttime populations. The nonemployment centers, which are often bedroom communities, were the net losers in the municipal income tax sweepstakes. Because the communities with negative tax exporting also grant their residents a tax credit, their collections are less than they would have been without the tax credit. The reduction in income tax reliance as a consequence of granting tax credits to residents who work in other cities has the effect of increasing property tax reliance of these municipalities.

## *The Municipal Quilt*

If there's one lesson to be drawn from this brief history of municipal revenues, it is that once cities are granted access to various revenue sources (or they exercise their home rule powers and diversify their revenue portfolios), it becomes nearly impossible to identify a prototypical American city that has all the qualities of the average city and, therefore, can be used as a benchmark against which all

other cities are compared. Nor can an average city prototype be designed as a standard for creating federal and state policies, with the expectation that all cities ought to respond or adapt to said policies in the same way. This statement comes as no surprise for a nation with over 19,492 incorporated municipalities, all with varying degrees of autonomy over the designs of their fiscal systems. Cities have created a crazy-quilt of revenue systems while not abandoning access to the property tax. Few cities have proposed abandoning access to the property tax, noting its reliability, its place-based importance, and its linkage—albeit a more tenuous link today than it was a century ago—to wealth, even as the property tax has become a much less significant contributor to municipalities' own-source revenue activity.

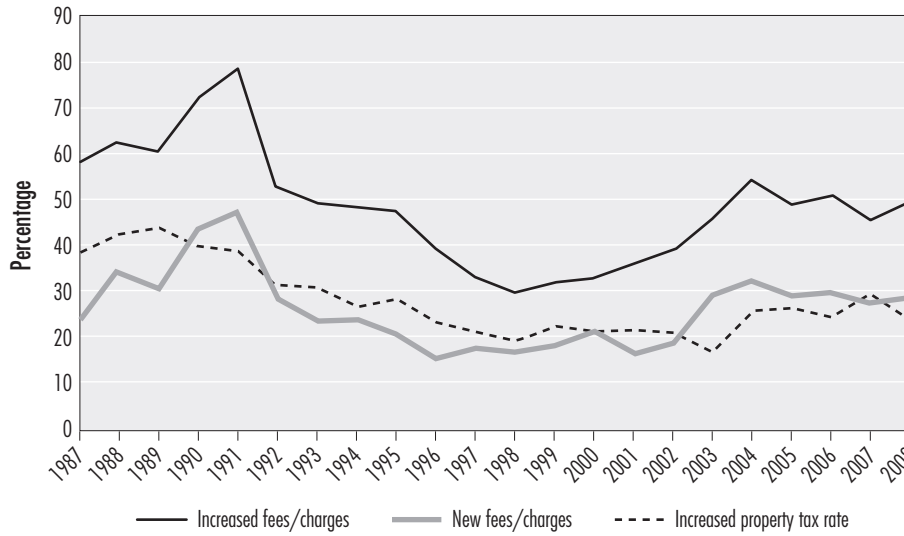
The revenue composition of municipalities' total revenues, especially of their general funds, illustrates the majority-minority reliance of certain revenues. On average, there is no majority own-source revenue, although user fees are becoming dominant. In some states, municipal reliance on a single revenue source (e.g., income tax in Cincinnati, sales tax in Oklahoma City, property tax in Boston) is such that there still is a dominant or majority revenue source. Just as the property tax constituted nearly all own-source revenues for municipalities a century ago, the sales tax, the income tax, and even the property tax carry that banner for some cities in some states. Most, however, are majority-minority revenue reliance cities.

In the future cities will continue to be encouraged to seek more and more services to which user fees can be attached. The composition of own-source revenues will probably tilt even more toward fees and charges. For the last two decades, when asked to identify a revenue action that their city had adopted in the last year, city finance officers have selected "increase the level/rate of user fees or charges" and "impose new fees or charges" at an astounding rate.[8] As figure 5.4 demonstrates, cities find raising fees and identifying new activities for which to charge fees a politically acceptable fiscal mechanism. Since 1987 nearly half of all responding cities have increased fees and charges each year, and another one-quarter of them have identified new activities on which to charge fees. The "increased property tax rate" line indicates that, even though there is a heightened sensitivity to the property tax, on average one in four responding cities has raised the property tax rate each of the last 20 years. Figure 5.4 identifies the percentage of responding cities that formally took the action of raising fees or the property tax; it does not indicate the magnitude (net increase in revenue) of the rate change.

The economic shock of the new normal—assuming it is more than just a momentary blip in historical gradualism (remember what $4 per gallon gas did to automobile and transit ridership?)—will encourage cities to adjust their revenue

8. Unpublished data taken from annual responses to the National League of Cities City Fiscal Conditions survey, 1987–2008.

**Figure 5.4**
Percentage of Cities Selecting Revenue Action During Previous 12 Months




Source: Unpublished data from the National League of Cities Annual City Fiscal Conditions Survey, 1987–2008.

portfolios to match their underlying economic base, or to transfer costs to other nonresidents, or to create a sustainable financial system, or any of dozens of possible revenue actions. The emerging quilt will take some time to design; of one thing we can be certain: it will not be the same design for all cities.

What is certain is that a typical municipal tax structure for the new normal will be variegated. The 2008–2009 economic shock to municipal fiscal structures ought to encourage municipalities to engage their states in a political discourse about reforming their revenue systems, such as:

- Broadening the sales tax base. As the retail sales tax base has narrowed as a percentage of consumer spending, is it time to reconsider a sales tax on services?
- Restructuring the property tax. As real estate loses much of its value in many cities, might cities consider moving from a uniform to a split-rate system and encouraging more land-intensive investment? Is the Pennsylvania model worth emulating?
- Experimenting. Tax structures that link closer to cities' underlying engines of growth or to income and wealth might be designed. Is a gross receipts tax (such as the business and occupation tax that operates in Washington State) a more accurate reflection of a city's tax base?

- Creating regional taxing powers. Municipalities will be looking for regional partners and allies in designing a system that is less destructive to the region's long-term interests and fairer in distributing the costs to the users.

The economic shock of the 2008 financial market and real estate collapse creates a political opening to redesign municipal fiscal systems. The conditions are ripe for an open and honest political dialogue on new financial structures for municipalities. The alternative is for the rapidly changing economic and fiscal situation to create a field day for analysts who see the fiscal world through the lenses of self-serving bureaucrats. The complex financial structure of cities could become even more complex, making it that much more ripe for fiscal illusion. My cloudy crystal ball rejects the latter alternative and—following the optimism of 2008 presidential candidate Barack Obama—says, *sí, se puede*, or "yes, we can!"

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