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MUNICIPAL REVENUES AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

Municipal Revenues and Land Policies

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Gregory K. Ingram and Yu-Hung Hong

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The Best of Times or the Worst of Times? How Alternative Revenue Structures Are Changing Local Government

Tracy M. Gordon and Kim Rueben

Scholars and policy makers often extol the virtues of the local public sector while also warning of its imminent decline. Subnational governments tend to be more sensitive to fluctuations in the business cycle because of their narrower economic base and limited monetary and fiscal policy tools. Balanced budget rules and debt limits further restrict their ability to run annual deficits. Moreover, the largest source of locally generated revenue—the property tax—is a frequent target of public scorn. Periods of great expansion in real estate values typically elicit calls for tax limits or restrictions. These calls are amplified when markets turn and values fall.

For example, as early as 1936, Professor Jens Jensen warned: "The seemingly prosperous years . . . were characterized by real estate booms, in which market values of real property rose to fabulous levels. With this fictitious prosperity came an increase of Governmental functions, which called for increased expenditures. . . . The collapse in 1929 reduced the actual income from real estate and deflated hopes of future incomes. . . . Real estate interests revived a demand of former depressions, that the tax levies be rigidly limited, preferably, in the Constitution" (126). This quotation seems prescient today.

It is certainly true that state and local governments are the workhorses of the American public sector. They provide the bulk of public goods and services in this

Carol Rosenberg provided excellent research assistance. All remaining errors are our own.

country, or about 60 percent of government consumption expenditures and gross investment, according to the *National Income and Product Accounts* (Bureau of Economic Analysis 2009). In fiscal year 2007–2008 state and local governments spent $7,164 per capita including federal grants, compared to the federal government's $7,784 excluding the value of these grants and $6,267 excluding grants and defense spending (OMB 2009). State and local governments employ more than 11 percent of the civilian labor force and have contributed an average of one-half percentage point to real annual GDP growth since World War II.

State and local governments are currently under tremendous fiscal strain. The Rockefeller Institute of Government reports that the second quarter of 2009 was the worst on record for states, with taxes declining nearly 17 percent compared to the same period in the previous year (Dadayan and Boyd 2009). Localities are facing revenue declines of their own. The National League of Cities reports that sales tax revenues were predicted to decline by 3.8 percent and income taxes by 1.3 percent at the end of fiscal year 2008–2009 (Pagano and Hoene 2009). Although property taxes have been experiencing modest growth, declines are expected over the next few years as assessments catch up with market values (Lutz 2008).

And yet, despite long-standing challenges, states and localities have adapted and innovated. Some localities have turned to increased aid from state governments. Others have adopted local income and sales taxes. Still others have implemented user fees and charges or explored new privatization and borrowing alternatives. What have these innovations wrought? How have they changed local government? We explore these questions below. After putting local revenue constraints in historical perspective, we synthesize research findings presented in earlier chapters from this book. Next, we suggest lessons for analysts and policy makers going forward. In particular, we argue that it is essential for proponents of local fiscal autonomy to relate changes on the revenue side of local budgets to expenditures and, ultimately, outcomes.

Property Tax Revolt: The Long View

Many commentators refer to the property tax revolt as a modern phenomenon beginning with California's passage of Proposition 13 in 1978. In fact, Proposition 13 was preceded by several unsuccessful property tax limitation measures at the ballot box and in the state legislature (Doerr 2000). Moreover, popular discontent with the property tax has deep historical roots.

Jensen (1936) notes that the property tax was initially administered along with the poll tax and a surtax on high-income individuals. It initially applied only to enumerated property types, but evolved into a general tax before the American Revolution. By the Civil War, states had also adopted uniformity provisions, requiring all nonexempt property to be taxed at the same rate.

With the debt crisis of the 1840s, states defaulted on borrowing for investments in banks, canals, and other transportation and infrastructure projects. Newly enacted debt restrictions limited state activities, and local governments

rose to take their place. By 1900 local revenues per capita exceeded state revenues by 260 percent. They surpassed even federal revenues by nearly 40 percent. The property tax provided 73 percent of locally generated revenues and 42 percent of combined federal, state, and local revenues. The property tax was particularly well suited to local governments because of the immobility of part of the base—land—and the link between payment of the tax and receipt of valued local services such as water, sewage, and streets (Wallis 2000).

The ascendance of the property tax also brought a political backlash, particularly at the state level, where the tax and service link was less well defined. Early efforts focused on overturning universality and uniformity provisions requiring that all property be fully assessed and taxed at the same rate. Classification emerged in the early twentieth century as a way to offer favorable tax rates, assessment practices, or tax credits for certain real property types, usually residential. Minnesota was the first state to move to a classified real property tax system in 1913, followed by Montana in 1917 and West Virginia in 1934 (J. Bowman 2009; Wallis 2000).

The Great Depression ushered in a new era of federal government dominance, including new spending programs as well as income taxes. At the same time, homeowners, who were increasingly unable to pay their property taxes, demanded relief. Texas became the first state to adopt a homestead exemption in 1932, and by the end of the decade nearly a quarter of all states had enacted similar measures (J. Bowman 2009). In the 1950s and 1960s these reforms gave way to more targeted relief measures geared toward low-income homeowners and the elderly. In particular, states began experimenting with circuit breakers and tax deferral programs. By 1973 every state had at least one residential property tax relief program in place (J. Bowman 2009).

As noted earlier, California's passage of Proposition 13 in 1978 was a watershed event. This constitutional amendment rolled back assessed values to 1975–1976 levels, capped tax rates at 1 percent, limited annual assessment increases to 2 percent per year unless a property changed hands, and required a two-thirds legislative majority for any state tax increase and a two-thirds popular vote for any new special local taxes. Its immediate effect was a 45 percent reduction in local property taxes in a single year. The decline was even greater for some types of local government: 57 percent for counties, 52 percent for nonenterprise special districts such as libraries, and 61 percent for school districts over two fiscal years (Haveman and Sexton 2008).

Similar measures were soon proposed in other states, including Arizona, Nevada, and Oregon. Notably, in 1980 Massachusetts citizens enacted Proposition 2½, reducing effective property tax rates to 2.5 percent and limiting future growth in levies to 2.5 percent per year unless local voters passed an override referendum. Isaac Martin (2009) estimated that Proposition 13 and its diffusion increased the probability of enacting a local property tax limit from one state every 10 years to two states per year.

Another round of more stringent tax limitations began in the 1990s with passage of Oregon's Measure 5 and Colorado's Taxpayer Bill of Rights (TABOR). TABOR was the most restrictive tax limitation measure yet, applying to all tax-

ing districts in the state and requiring voter approval of any changes to tax rates or assessment practices as well as the imposition of any new taxes. The law explicitly prohibited certain taxes, including new or increased real estate transfer taxes, local income taxes, state property taxes, and state income tax surcharges. Perhaps most important, TABOR restricted general revenues to the prior year's level adjusted for population growth and inflation and required the return of any revenue beyond this level to taxpayers through tax cuts or rebates. Voters had to approve changes to this growth formula and to other spending or revenue limits. In November 2005 voters did just that, suspending TABOR for five years and resetting the revenue limit at a higher level (McGuire and Rueben 2006).

Taken together, these developments have diminished the property tax over time. Between 1977 and 2007 property taxes dropped from 31 to 24 percent of total local revenues (table 16.1) and 50 to 36 percent of own-source or locally generated revenues. As in California, declines were pronounced for some government types, especially in the years immediately following the modern tax revolt. For county governments as a whole, property taxes fell from 30 to 24 percent of total revenues, and for school districts the drop was from 42 to 34 percent. In cities and special districts, property tax losses were less severe, but still reflected large percentage changes in the reliance on the property tax (from 24 to 19 percent and from 11 to 9 percent of total revenues, respectively). The property tax revolt also affected some states more than others. Vermont saw its property tax share decrease by nearly 40 percentage points between 1977 and 2007, whereas Maine had a 7 percentage point upswing despite several property tax relief measures enacted in the 2000s (table 16.2).

This historical record points to several lessons for today. First, although celebrated by many tax scholars and administrators for its ability to generate a healthy and reliable stream of revenues with minimal disruptions to economic activity (according to the benefit view; see chapter 15 in this volume), the property tax has long been a target of public scorn for its perceived unfairness or regressivity. For example, 42 percent of respondents cited the property tax as the "worst tax" in a 2005 Gallup/CNN/*USA Today* poll (K. Bowman 2009).

As noted by Youngman (2002), among others, concerns about regressivity are often misplaced. However, as she notes, there are seeds of discontent with the property tax even among economists. Some economists endorse the traditional view of the property tax as a regressive tax on housing while others allow that even a progressive tax on capital may have regressive local excise tax effects. (See chapter 15 in this volume for a further discussion of normative properties of the property tax and its competitors.)

In any event, voters have repeatedly acted on their antipathy toward the property tax by limiting its reach. As of 2006, 43 states restricted the property tax through limits on rates (34 states), levies (29 states), and/or assessments (20 states) (Anderson 2006). This trend shows no signs of abating, despite falling home values. In 2007 lawmakers in 27 states considered additional relief measures (Hamilton 2007), and Florida, Georgia, Indiana, and Texas contemplated eliminating the property tax altogether (Fisher, Bristle, and Prasad 2009).

Table 16.1
Percentage of Total Revenue from Property Tax: Levels of Local Government

Year	All Local	County	City	Special District	School District
1977	30.7	30.3	24.1	11.0	42.0
1978	29.9	29.7	23.2	10.0	41.0
1979	26.6	25.4	21.4	9.2	36.8
1980	25.4	25.5	20.6	8.5	34.3
1981	25.0	25.3	20.1	8.0	34.4
1982	25.0	25.9	19.5	7.3	35.7
1983	25.4	26.8	19.4	7.2	36.7
1984	25.3	26.7	19.2	7.7	36.7
1985	24.8	26.2	18.6	7.7	36.3
1986	24.7	26.2	18.4	7.6	36.1
1987	24.7	25.9	18.8	7.6	36.2
1988	25.7	26.9	19.8	8.9	36.4
1989	25.8	26.9	20.4	7.9	36.0
1990	25.9	26.9	20.4	8.0	36.5
1991	26.4	27.2	20.9	8.3	37.0
1992	26.4	26.7	21.1	7.9	37.3
1993	26.7	n.a.	n.a.	n.a.	n.a.
1994	26.2	n.a.	n.a.	n.a.	n.a.
1995	25.6	n.a.	n.a.	n.a.	n.a.
1996	24.8	n.a.	n.a.	n.a.	n.a.
1997	24.5	23.4	19.2	8.8	35.8
1998	24.1	n.a.	n.a.	n.a.	n.a.
1999	23.9	n.a.	n.a.	n.a.	n.a.
2000	23.5	n.a.	n.a.	n.a.	n.a.
2001	23.7	22.9	19.3	8.5	32.9
2002	24.9	23.9	20.7	8.3	34.2
2003	25.1	24.2	20.9	8.6	34.3
2004	24.6	n.a.	n.a.	n.a.	n.a.
2005	24.8	n.a.	n.a.	n.a.	n.a.
2006	24.7	n.a.	n.a.	n.a.	n.a.
2007	24.1	23.7	19.2	8.7	34.5

Source: State and Local Government Finance Data Query System (2010).

Table 16.2
Percentage of Total Revenue from Property Tax: States (all local governments)

	1977	2007	Percentage Point Change
Vermont	54.7	15.1	–39.6
California	34.7	15.0	–19.8
South Dakota	48.7	29.6	–19.1
Wyoming	38.9	23.0	–16.0
Massachusetts	51.5	35.6	–15.9
Montana	44.5	28.8	–15.7
Oregon	38.5	24.1	–14.3
Arkansas	21.2	8.5	–12.7
Idaho	32.8	21.4	–11.4
Kansas	37.7	27.4	–10.3
Arizona	28.1	18.2	–9.9
Indiana	34.3	25.0	–9.3
Colorado	31.5	22.7	–8.8
Michigan	34.0	25.6	–8.4
Utah	28.6	20.4	–8.1
New Hampshire	61.3	53.2	–8.1
Nebraska	30.8	23.1	–7.6
Connecticut	57.9	51.3	–6.6
Nevada	26.1	19.7	–6.3
Iowa	34.2	28.6	–5.6
Missouri	28.9	23.3	–5.6
Oklahoma	21.6	16.0	–5.6
Minnesota	26.0	21.1	–4.9
New York	27.8	22.9	–4.9
Illinois	36.1	31.5	–4.6
Ohio	29.6	25.1	–4.5
Rhode Island	51.7	48.0	–3.7
North Dakota	33.7	30.7	–2.9
Kentucky	19.3	16.6	–2.8
Georgia	25.2	22.6	–2.6
New Mexico	14.9	12.5	–2.4
Washington	18.4	16.4	–2.0
Tennessee	17.2	15.5	–1.7
Maryland	25.0	23.4	–1.6

(continued)

Table 16.2
(continued)

	1977	2007	Percentage Point Change
Louisiana	14.4	13.7	–0.8
Mississippi	19.3	18.7	–0.6
Pennsylvania	27.4	26.9	–0.5
Texas	32.6	32.6	0.0
Delaware	18.3	18.5	0.2
West Virginia	22.8	23.1	0.3
North Carolina	19.2	19.9	0.7
Alabama	8.5	9.3	0.8
South Carolina	24.9	25.8	1.0
Alaska	23.5	24.5	1.0
Virginia	28.5	29.7	1.2
New Jersey	50.1	52.1	2.0
Wisconsin	30.1	32.5	2.4
Florida	23.9	27.7	3.9
District of Columbia	7.5	13.3	5.8
Maine	40.0	47.4	7.3
Hawaii	36.4	44.1	7.8

Source: State and Local Government Finance Data Query System (2010).

Revenue sources ebb and flow in response to economic shocks, policy shifts, and technological advances in collection and administration. Governments adapt, although their ability to do so may depend on institutional rules and constraints, such as constitutional authorization to levy a local sales or income tax. Political constraints are also important. Voters may be willing to accept new revenues when the link to services is made explicit. In Colorado, for example, concerns about declining quality in public education and other services were a key motivating factor in voters' loosening of TABOR's revenue restrictions. Conversely, political constraints may restrict governments' ability to tap new revenue sources even in the absence of explicit limits. For example, Rueben and Cerdán (2003) show that certain California cities have been perpetually frustrated in their attempts to pass new tax and bond measures since passage of Proposition 13.

How Have Localities Fared? A Synthesis of Research Findings

As several contributors to this volume have noted, local governments vary enormously in size, organization, and scope. Not all local governments have access to the alternative revenues described here, and not all with access choose to exercise

it. There is a tendency toward path dependence, or the continuation of past practices. Take up or implementation of authorized revenue sources will also depend on the availability of alternatives, voter preferences, and the presence of other institutions such as strong mayors (chapter 2) or professional board members (chapter 9). As a result, inferring the effectiveness of a particular revenue instrument is complicated, and the ability to generalize from past experience may be limited.

A further complication is limited data. Several contributors have noted the absence of centralized data sources for their revenue instruments of interest. For example, the U.S. Census of Governments does not collect data on so-called private governments, such as business improvement districts (BIDs) and homeowners associations in planned developments, condominiums, and cooperatives. Although the American Housing Survey (AHS) includes questions about residences with restricted access or security (which could proxy for private homeowners associations), respondents have interpreted these questions more broadly to include apartments and public housing units (Sanchez and Lang 2002).

Where the Census Bureau does provide information, it may vary from what researchers have found. For example, Mikesell finds that 36 states have a local option sales tax and 14 have an income tax (chapter 6), whereas Benton reports 33 and 15 (chapter 4) and Sjoquist and Stephenson cite 33 and 14 (chapter 15). These discrepancies may result from different understandings or usages of revenue concepts (e.g., whether to count the payroll tax as an income tax) as well as year-to-year variation in publicly available data.[1]

Simulation provides an alternative strategy for using incomplete or less than ideal data. For example, in chapter 10 Brooks and Meltzer used data from Los Angeles and New York to extrapolate an upper bound of BID adoption nationally and estimate the effects of BIDs on government finances. Similarly, in chapter 11 Merriman simulated the life cycle of a TIF to illustrate its potential effects on local revenue volatility.

With these caveats in mind, how have alternative revenues fared? Have they replaced lost property tax revenues, and to what effect? Wildasin notes in chapter 3 that local governments derive about 40 percent of their total revenues from federal and state transfers, and this figure is even greater for some government types (school districts).[2] The bulk of federal transfers to states and localities fund payments to individuals (e.g., Medicaid and cash welfare), whereas most state transfers to localities support elementary and secondary education.

Intergovernmental revenues have not replaced lost property taxes, however. Wildasin shows that, although it increased slightly in the years immediately

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1. On a more positive note, the Census Bureau's Governments Division is continually improving its data and documentation as well as access to them for researchers. The division has recently revised outdated or redundant classifications and will likely continue to do so. Of course, even beneficial revisions impose research problems by creating discontinuities in a data time series.

2. This amount does not include other forms of intergovernmental assistance such as tax and regulatory coordination.

following Proposition 13, the proportion of local revenues coming from higher levels of government has remained fairly constant since 1982. Moreover, increased state support for education is often a consequence not of the property tax revolt but of school finance reform. In fact, as noted by Fischel (1989) and others, court mandates to equalize school finance may themselves have precipitated the property tax revolt.

More important, intergovernmental funds often come with mandates or strings attached. The design of these programs is fraught with difficulty from the perspective of the donor government because of concerns about moral hazard or weakening local fiscal discipline. However, Wildasin finds little evidence for this behavior in a panel of about 1,000 U.S. municipalities over more than 25 years, and in chapter 2 Inman detects a similarly muted response of states to federal aid.

This lack of responsiveness is surprising and troubling from the perspective of donor governments, which may wish to stimulate certain types of spending. Nevertheless, as Smart (in his commentary for chapter 3) and Wildasin point out, the structure of intergovernmental grant programs is itself endogenous, reflecting the winners and losers of earlier political contests over funding formulas, maintenance of effort requirements, and so forth. The same dynamic may be at work in the recent federal stimulus package.

Another issue with intergovernmental aid is that it can be poorly targeted. For example, school finance equalization formulas often fail to recognize that poor students can live in property-rich districts (e.g., Fischel 2009; Sonstelie, Brunner, and Ardon 2000). Thus, centralized financing can fail both efficiency and equity criteria. This is a standard critique of place-based versus people-based aid (Ladd 1993).

Local income and sales taxes are more appealing than intergovernmental grants to local governments because they provide discretionary revenues, although sales taxes can sometimes be earmarked for specific purposes such as transportation. As noted above, a limited number of states authorize local income and sales taxes, and not all localities adopt these revenue instruments where they are authorized (tables 16.3 and 16.4). However, as Mikesell points out in chapter 6, these sources yield more revenue than the property tax in some large cities (e.g., Columbus, Denver, Detroit, New York, Philadelphia, and Phoenix).

Variation in access and take-up rates for local option taxes raises issues of tax competition and coordination. Jurisdictions will attempt to export the burden of these taxes to nonresidents where possible, through commuter or transient occupancy (hotel) taxes, for example, or a general sales tax that falls on shoppers from neighboring areas. As a result, taxpayers may be subject to multiple taxes with cascading rates and an array of conflicting exclusions and deductions. The result is a complicated system that violates normative principles of efficiency as well as equity (by treating equivalent taxpayers differently and exacerbating economic disparities across jurisdictions). Mikesell further shows that these taxes are more volatile than the property tax due to policy changes (e.g., legislative changes to

Table 16.3
Percentage of Total Revenue from Local Income Tax, by Year and State (all local governments)

	1977	2007	Percentage Point Change
Maryland	9.4	16.0	6.6
Indiana	1.0	2.5	1.5
Ohio	6.7	7.6	0.9
Kentucky	7.3	7.9	0.6
Iowa	0.0	0.6	0.6
New York	4.6	4.9	0.2
Oregon	0.0	0.1	0.1
Tennessee	0.0	0.0	0.0
Kansas	0.0	0.0	0.0
Virginia	0.0	0.0	0.0
Louisiana	0.0	0.0	0.0
Colorado	0.0	0.0	0.0
District of Columbia	11.7	11.5	–0.1
Delaware	2.3	1.6	–0.7
Alabama	0.9	0.2	–0.7
Missouri	2.7	1.5	–1.2
Michigan	2.2	1.0	–1.2
Pennsylvania	9.0	6.1	–2.9

Source: State and Local Government Finance Data Query System (2010).

the tax rate) and the business cycle. Sjoquist and Stephenson also compare the normative properties of local property, sales, and income taxes (chapter 15).

Many local governments have come to rely more on user fees and charges since the modern property tax revolt. In chapter 4 Benton points out that the share of general revenues from charges increased from 19 to 28 percent for cities and from 12 to 27 percent for counties between 1962 and 2002 (and by greater proportions in smaller jurisdictions). Using a broader definition of revenues encompassing utilities (gas, water, electric, and transit) in chapter 5, Pagano finds that real user fees per capita grew from $349 to $546 between 1977 and 2002, a 6.5 percent average annual increase, compared to 3.4 percent for general taxes. There is, however, substantial variability in this trend (table 16.5).[3]

A similar trend occurred after the Great Depression. Pagano observes that user fees and charges were a natural response to the property tax revolt of that

3. The table is based on a still broader concept of fees and charges that includes miscellaneous revenues, or special assessments and fines, as in Netzer (1992).

Table 16.4
Percentage of Total Revenue from Local General Sales Tax, by Year and State (all local governments)

	1977	2007	Percentage Point Change
Arkansas	0.1	10.5	10.5
New Mexico	1.2	9.8	8.6
Georgia	2.3	9.5	7.3
South Dakota	2.4	9.3	6.9
Louisiana	13.1	18.9	5.8
Kansas	0.7	6.3	5.6
Arizona	4.7	9.5	4.8
Oklahoma	7.6	11.9	4.3
Iowa	0.0	4.2	4.2
North Dakota	0.0	3.8	3.8
Missouri	4.1	7.8	3.7
Colorado	7.9	11.5	3.6
Washington	3.3	6.4	3.2
Wyoming	2.5	5.5	2.9
Alabama	6.1	8.9	2.8
Ohio	1.3	3.1	1.9
North Carolina	3.6	5.2	1.6
Florida	0.0	1.4	1.4
Utah	4.7	6.1	1.4
Texas	3.3	4.6	1.3
Nebraska	1.2	2.4	1.2
Wisconsin	0.0	1.1	1.1
District of Columbia	6.4	7.4	1.0
New York	5.9	6.7	0.8
South Carolina	0.0	0.7	0.7
Tennessee	5.5	6.0	0.4
Pennsylvania	0.0	0.4	0.4
Vermont	0.0	0.2	0.2
Minnesota	0.1	0.3	0.2
California	3.4	3.5	0.1
West Virginia	0.0	0.0	0.0
Idaho	0.0	0.0	0.0
Mississippi	0.0	0.0	0.0
Nevada	3.0	2.3	–0.7

Table 16.4
(continued)

	1977	2007	Percentage Point Change
Virginia	4.2	3.1	–1.1
Alaska	5.8	4.5	–1.3
Illinois	4.1	2.0	–2.0

Source: State and Local Government Finance Data Query System (2010).

era, as well as to technological advances such as parking and water meters. From 1945 to 1977 fees and charges rose by 3.9 percent per year, a less dramatic growth rate than in the modern era, but nevertheless substantial. In the current recession, attention has again turned to fees and charges, often enabled by new technologies such as speed detection cameras, electronic vehicle transponders, and global positioning systems (Hanak 2009). Local governments have also become more creative in levying new accident response and streetlight user fees (Segal 2009).

Fees are often praised as a way to bring in additional revenues and enhance government efficiency. Nevertheless, there are limits to the ability to charge for goods and services. By definition, local governments typically provide public or quasi-public goods that do not easily lend themselves to market pricing. Where charges are possible, they may generate a political backlash (e.g., Segal 2009). Even fees for popular services, such as parks, may threaten support for less popular programs as well as create burdens for low-income residents. Thus, user charges may be appropriate for some goods and services (e.g., tennis courts and golf courses) and not for others (e.g., K–12 education, or mosquito abatement and flood control districts when there can be positive externalities).

Similar to user fees and charges, privatization has been advanced as a potential solution to local revenue challenges. Privatization includes not only contracting out for services and selling off or leasing assets (chapter 14), but also delegating traditional municipal functions to voluntary businesses or homeowners associations (BIDs and HOAs; chapters 10 and 12). These associations provide many traditional municipal services such as garbage collection, street cleaning and lighting, and security patrols.[4]

Both versions of privatization are controversial because of incomplete contracts over property rights. For example, as Gómez-Ibáñez recounts in chapter 14, private high-occupancy toll lanes such as California's SR-91 have been stymied

4. BIDs differ from HOAs in that they are formed retroactively through a vote of commercial property owners. If the BID wins, even those who voted against it are obligated to pay assessments. In this sense, they are closer to the community facilities districts (CFDs) surveyed by Chapman in chapter 13.

Table 16.5
Percentage of Total Revenue from Fees, Charges, and Miscellaneous Revenues, by Year and State

	1977	2007	Percentage Point Change
Utah	20.9	39.4	18.5
Indiana	21.8	37.4	15.6
Idaho	22.0	36.2	14.1
South Carolina	28.0	41.3	13.2
District of Columbia	8.8	20.8	12.0
North Carolina	22.5	34.4	11.9
Montana	18.2	28.7	10.5
Colorado	24.7	34.9	10.3
Minnesota	21.6	31.7	10.1
Oregon	22.0	31.9	9.8
California	19.3	29.1	9.8
South Dakota	19.1	28.8	9.7
Hawaii	18.9	28.4	9.5
Oklahoma	23.3	32.2	8.8
Iowa	23.2	31.3	8.1
West Virginia	17.1	25.1	7.9
Rhode Island	7.8	15.6	7.9
Missouri	24.0	31.3	7.3
Massachusetts	14.4	21.0	6.6
Arizona	26.4	32.9	6.5
New Jersey	11.0	17.3	6.2
Mississippi	30.2	36.2	6.0
Wyoming	26.1	32.0	5.8
Maine	12.1	17.7	5.6
Louisiana	24.2	29.7	5.6
Washington	34.9	40.2	5.3
Kentucky	27.6	32.7	5.0
Illinois	18.0	23.0	5.0
Delaware	25.0	29.8	4.8
Michigan	20.1	25.0	4.8
Pennsylvania	17.2	21.9	4.7
Vermont	15.8	20.5	4.7
North Dakota	22.8	27.2	4.5
Wisconsin	17.1	21.6	4.4

Table 16.5
(continued)

	1977	2007	Percentage Point Change
Alaska	25.3	29.5	4.2
Florida	32.3	36.4	4.1
Nevada	29.1	33.0	3.9
Virginia	17.3	21.1	3.8
Tennessee	45.9	48.9	3.1
New York	14.5	17.3	2.8
New Mexico	19.6	22.0	2.3
Maryland	14.2	16.1	1.9
Kansas	29.4	31.3	1.9
Ohio	21.8	23.5	1.7
Texas	29.9	31.6	1.7
Alabama	39.0	40.4	1.4
Connecticut	11.9	13.3	1.4
Georgia	34.2	35.0	0.8
New Hampshire	14.2	14.6	0.3
Nebraska	47.3	47.6	0.3
Arkansas	29.1	27.6	–1.5

Source: State and Local Government Finance Data Query System (2010).

by disputes over concessionaire profits and limits on building competing roads. In chapter 12 Cheung notes that HOA residents are often dismayed to find they are subject to more stringent land use controls (conditions, covenants, and restrictions, or CCRs) than they realized when purchasing their homes. Another common issue is the potential exclusion of some individuals (e.g., nonmembers or nonpayers) from receiving services.

So-called private governments have proliferated dramatically in recent years. Cheung observes that HOAs increased from a few hundred organizations in the early 1960s to an estimated 231,000 in 2002, and in chapter 10 Brooks and Meltzer report that there are 700 BIDs in the United States and more internationally. However, fiscal effects of these entities appear to be minimal. As discussed above, although they simulate an upper bound, Brooks and Meltzer detect little effect of BIDs on municipal revenue or expenditure patterns regardless of the assumptions about BIDs as substitutes or complements for traditional local government. Similarly, Cheung finds that in California a 10 percent increase in the number of CIDs reduces municipal expenditures by 1.5 percent and revenues by 1.7 percent.

The fiscal consequences of private governments may be limited because these organizations tend to be small: two-thirds of California CIDs have annual budgets of less than $100,000, while the average Los Angeles BID spends just over $670,000 per year. On the other hand, the size distributions of these communities have long tails. Hence, a large BID or CID in a small jurisdiction may wield a large influence in either decision making or siphoning off funds.

A final way that local governments have coped with threats to the property tax is through the use of nontraditional infrastructure financing (TIFs, developer impact fees, and "non-vanilla" borrowing methods such as certificates of participation and CFDs). It is particularly difficult for researchers to assess the prevalence and effectiveness of these funds because of limited data. They are often similarly unobservable to voters. Although a vote is required to establish a CFD, it is a vote of property owners, not all residents of the community. TIFs do not require voter approval although they siphon property taxes that would have otherwise gone to general revenues. The boundaries of both TIFs and CFDs are subject to political manipulation and can be designed to ensure approval. This lack of transparency is particularly troubling in light of higher default rates for some nontraditional borrowing relative to general obligation bonds.

In sum, local governments have enacted a variety of new revenue instruments in response to ongoing threats to the mainstay of the property tax. Although some alternatives may be appropriate and even desirable for some jurisdictions, none is a panacea for the loss of a discretionary revenue source as major as the property tax. Moreover, as shown in greater detail by Sjoquist and Stephenson in chapter 15, many alternatives do not fare well on the normative principles of taxation. What is a locality to do? We now turn to this question.

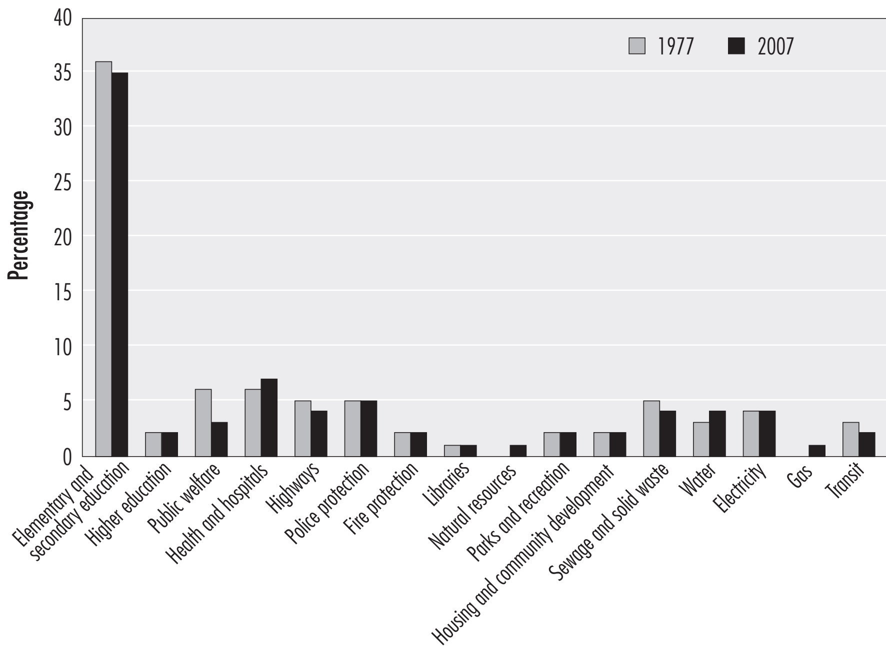
What Should Localities Do? Lessons for the Future

To all but the most informed observers, concepts such as intergovernmental relations and local fiscal autonomy are abstractions with no clear meaning. Perennial disputes between state and local governments or federal and state governments about grants, tax authority, and service responsibility—which Benton compares to parents and their children—can be arcane and even alienating. Arguably, what matters most to voters is not who provides or finances government services, but their level and quality.

A key question, then, is how the modern property tax revolt and shifts to alternative revenue instruments have affected services. It is notoriously difficult to link revenues to spending and outcomes, but a cursory examination of the data reveals little difference in spending shares by major category or function over time (figure 16.1).

Why is there so much stability in government spending? One reason may be the level of aggregation reflected in the Census Bureau's major functional categories. In addition, aggregating up to the state or regional level of geography can mask changes in spending across localities within a state. However, it is clear that local spending as a share of personal income has rarely declined over the past

Figure 16.1
Shares of Total Spending for Local Governments



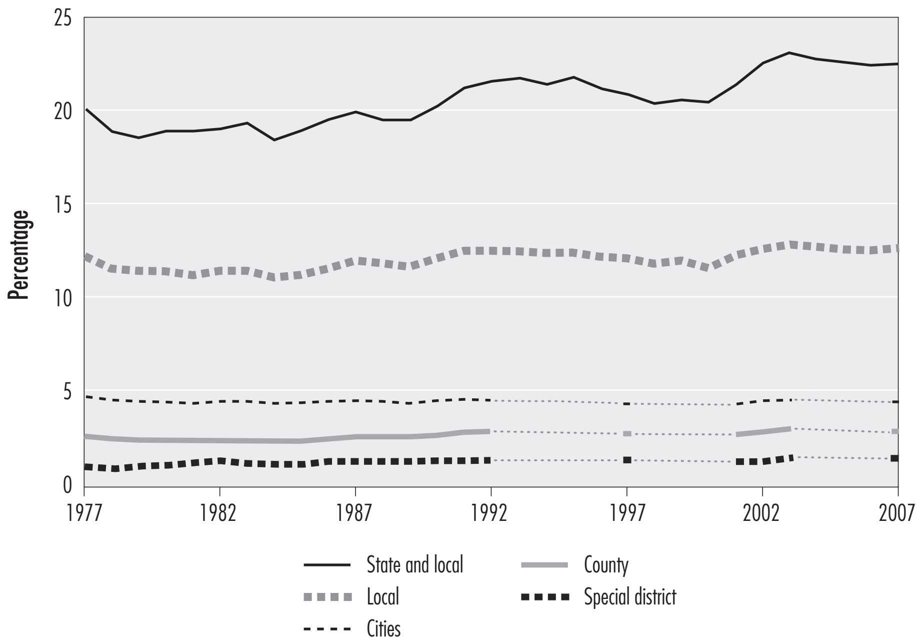
Note: Categories do not include air transportation (airports), parking, corrections, other education, financial administration, public buildings, water transportation (port facilities), interest on general debt, and other general expenditures (includes miscellaneous commercial activities, protective inspection and regulation, veterans' services).
Source: State and Local Government Finance Data Query System (2010).

30 years, although there have been changes in the allocation of state versus local program responsibility (figure 16.2). Some observers argue that this pattern demonstrates the inexorable growth of a Leviathan-like government (e.g., Edwards 2008). Others point to the power of public-sector labor unions to extract higher wages, particularly in large cities (e.g., Fischel 2001; Inman 2009).

Some evidence shows that public-sector employees are paid more than private workers in comparable occupations or with similar skills, education, and experience (e.g., Gordon et al. 2007). However, cutting labor costs is difficult not only because of collective bargaining rules, but also because the costs are concentrated in politically popular areas, such as K–12 education and public safety. Voters often judge the quality of these services based on the amount of labor involved (e.g., more teachers per student or police per capita). As has been argued recently, state and local employment cuts can also be harmful in an economic downturn.

The stability of government spending over time suggests a strategy: voters should be made to feel the pain of their choices at the margin. Do alternative revenue instruments take us in this direction? It depends. Some alternatives—state

Figure 16.2
Total Expenditures as a Percentage of Personal Income



Note: The dotted lines represent estimated numbers.
Source: State and Local Government Finance Data Query System (2010).

aid, tax base sharing, and TIFs—may actually weaken the link between taxes paid and services received. As a result, the quality of public services may suffer. For example, there is evidence that the quality of K–12 education suffered in California as a result of the centralization of school finance after Proposition 13 (e.g., Sonstelie, Brunner, and Ardon 2000). Other solutions—privatization, user fees, and delegation to submunicipal governments—can, if properly designed, improve this connection.

Several contributors have argued that the key to proper local government revenue tools is transparency. However, as implemented, some of the alternatives discussed in this volume can also obfuscate rather than clarify the situation for voters and their elected representatives. For example, in chapter 7 Burge notes that the relationship between impact fees and the costs of growth is often unclear. Mikesell points out in chapter 6 that the base for local option sales taxes can be so complex as to bear little relationship to the service provision costs. Pagano argues in chapter 5 that revenue diversification itself can exacerbate fiscal illusion.

Limited transparency may not be a bad thing. In chapter 13 Chapman refers to cases of "justifiable corruption," where local governments resort to ever more complex borrowing methods to raise necessary funds that voters might not other-

wise approve. Some evidence also exists that less salient taxes do not affect consumption of the product that is being taxed (Chetty, Looney, and Kroft 2008).

Yet, the budget constraint is inescapable. Consumers may not notice taxes they are paying, but they will still have less money to spend on all other goods. Analogously, short-term fiscal illusion in the public sector may give way to growing cynicism or distrust of government in the longer term. In the end, justifiable corruption may be neither justifiable nor expedient.

So what is a locality to do? What are the limits to localism? Again, it depends on the type of good or service provided. Oates (1972) shows that the benefits of decentralization depend on the degree of preference heterogeneity in an area and the absence of scale economies or equity concerns about goods such as K–12 education.

In chapter 2 Inman proposes a taxonomy of public finance that incorporates many of these considerations. For example, he suggests that K–12 education, police, and fire protection should all be coordinated at a fairly local level (with citywide school finance equalization). Courts, prisons, and environmental services should be provided at a slightly higher level of government. Services with significant scale economies, including waste disposal, water, and sewers, should be provided at a higher level still. For some services, such as social insurance (e.g., unemployment insurance and cash welfare), the right level of government might be federal or might not yet exist (e.g., metropolitan area or region). In addition, Inman argues for matching revenues paid with benefit received. Thus, business taxes should fund services consumed by businesses, and resident taxes services for residents. As he notes, in practice some services will benefit both groups (e.g., roads, police protection) and thus should be funded by both sets of users.

This specific allocation may be debatable. However, the key point is that local governments must show value for the money they raise. The test for any system should be whether it delivers better outcomes or outputs. Federal aid for elementary and secondary education is moving in this direction with the introduction and expansion of the No Child Left Behind Act and certain provisions in the recently enacted stimulus package. Similarly, local elected officials should be able to demonstrate how their public finance system promotes economic growth or the well-being of firms and residents and is sustainable into the future.

Conclusions

This chapter began with an excerpt from Jensen (1936) decrying the volatility of local revenues and political opposition to the property tax. He nevertheless concluded on an optimistic note: "The movement, at one time threaten[ing] to eliminate all property taxation, appears largely to have spent itself. . . . It is improbable that legislatures, faced with the task of discovering new revenue sources will joyfully mutilate their most dependable source" (126).

Unfortunately, this optimism seems to have been unwarranted. Swings in revenue, unrelenting service demands, and threats to the property tax appear to be facts of life for states and localities. Yet, local governments have managed to

survive and innovate. In this new era of fiscal challenges, it is an auspicious time to review results of their efforts.

It might also be a favorable time to rethink government organization and whether certain revenues and expenditures might be better assigned to other levels of government or the private sector. As Michael Wasylenko, William Fox, and others have suggested in their commentaries in this volume, this might be the time for wholesale reform rather than for tinkering around the edges. For example, should neighborhood districts take over K–12 education with citywide financing, as Inman suggests? Should states forego the sales tax in exchange for the federal government assuming responsibility for Medicaid as proposed by Burman (2009)?

Many authors in this volume have emphasized the desirability of experimentation and choice, for example, allowing localities to continue innovating with alternative revenue and borrowing devices. However, this process will clearly involve winners and losers, including potential holdouts. How do we make these trade-offs? What people or places should be compensated? How can higher levels of government reward innovation at lower levels?

These questions are difficult enough in flush economic times and may seem impossible given current budget shortfalls. Federal or state governments could play a role in expanding choice for local governments—the state by expanding tax instruments available to localities or the federal government by relaxing rules concerning intergovernmental funds. These freedoms would have to be weighed against potential negative incentive effects. In any event, moving forward will require a much fuller understanding of our current multilayered system of public finance. Although this volume has provided a good start in laying out new revenue options and their effectiveness, there is much more to learn about how different revenue sources, expenditure goals, and levels of governments interact.

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