LOCAL GOVERNMENT FINANCE ISSUES IN THE UNITED STATES

Prepared by
Dr. Robert L. Bish, Professor Emeritus
University of Victoria

Local government finance issues in the United States vary among the 50 states. This diversity, however, provides a great opportunity to observe different financing systems, different problems and a wide variety of consequences from the introduction of different local government revenue sources. This huge laboratory is especially useful because of the lack of financing diversity in the Canadian system from which to learn about local government finance alternatives[1]. U.S. cities also provide an opportunity for Canadians to learn about urban problems because many U.S. cities are older and larger and have encountered the problems of aging central cities earlier than Canadian cities. The objective of this review is to describe local government finance issues in the United States to provide background for Canadians.

The time available for this report has been quite brief. The review begins with a focus on local government finance issues and is followed by the identification of problems and proposals by some of the local government based national associations. It will be observed that there is not a close coincidence between national local government organization concerns and local government finance issues because it is the states, not the national government, that determines

---

[1]The most common local government pattern among the 50 states includes counties which both deliver some state funded services, act as local governments for rural areas, and provide some services for both rural areas and cities within the county. There are also states without counties where the state delivers rural services, states where counties do not overlap cities, and some large city governments that are simultaneously a city and a county. In some states there are also township governments, which may provide education and under take a few additional activities that would otherwise be provided by a municipality or county, including local roads, volunteer fire protection and water systems. Most states, but predominantly in the West where counties are geographically larger than in the East, there are also many special districts which provide one or more specific services in their area. Most states also have school districts with independently elected school boards, but there are examples of schools being the responsibility of a city or county government. One issue that must be recognized is that 85 percent of general local governments (cities, counties and townships) are under 10,000 population and nearly half are under 1000 population. In contrast to the large number of small local governments, in 1998 42 percent of the US population resided in the 218 municipalities over 100,000 population. Aggregate statistics on revenues and expenditures are dominated by the small number of large municipalities. For a book that covers all forms of local government in the United States see Vincent Ostrom, Robert L. Bish and Elinor Ostrom, *Local Government in the United States*, San Francisco: Institute for Contemporary Studies, 1988.

the framework under which local governments operate[2]. The national local government organizations, however, do lobby for national programs which provide revenues from the national government for their members.

LOCAL GOVERNMENT FINANCE ISSUES[3]

Most cities in the United States have similar responsibilities to cities in Canada (policing, fire, transportation, utilities, recreation) although there is a lot of variance from state to state. However, some of the largest cities in the United States have additional responsibilities, including hospitals, and some report revenues raised for education although the schools are generally run by a separate school board and set their tax rates independently. In some of these cases the responsibilities arise not from being a municipality, but from performing city and county functions simultaneously. New York City, for example is simultaneously the government for 5 counties.

Historically the most important local government own-source revenues were the property tax, user charges (primarily for utilities) and selective sales taxes on liquor, tobacco and fuel. More recently a majority of states have allowed general sales taxes and local income taxes. General sales tax authorization virtually always requires state collection and a combination of

---

[2]In some states the state legislature passes the relevant legislation similar to a Canadian provincial government setting forth a framework in a municipal act. In other states, however, local government authority is set forth in the state constitution, not state legislation, and local governments determine their own operating rules. In some states, state legislation or the state constitution, provides for "home rule" (where municipalities can either use state legislation or set their own processes), for "Charters" (where a government may draft its own governing legislation), or both. Again, diversity prevails.

[3]Sources of information on local government finance issues are diverse and since the discontinuation of the Advisory Commission on Intergovernmental Relations in the early 1990's, extremely difficult to come by. For details on local government sales and income taxation the ACIR publications, *Local Revenue Diversification: Local Income Taxes* (1988) and *Local Revenue Diversification: Local Sales Taxes* (1989) remain the best source. The ACIR *Significant Features of Fiscal Federalism*, formerly annual, is also quite detailed. The Census of Governments provides financial information but it can be hard to interpret and the annual *Government Finances* only includes provides breakdowns for counties over 200,000 population and cities over 100, population. This results in the omission of about 10 states for any county-city breakdowns of local government taxing or spending. The *Census of Governments* provides statistics every 5 years that is most comprehensive but still has problems in relating financial information to how local governments are organized in relation to government owned corporations and special districts.

limits and administration have limited local government ability to set their own rates or specify a tax base different from that of their state. More discretion is permitted with income taxes and they are levied on payrolls or gross income as well as piggy backing on state income tax definitions. Income tax revenues are only a major source of revenue for local governments in three states (two include counties and cities; a third, school districts and cities) and about thirty large cities, primarily in the northeastern mid-west and northeast.

During the past 3 decades there have been three very important trends in local government finance in the United States. One is an increased number of Tax and Expenditure Limits (TELs) placed on local governments either through referenda or by state legislatures. Second is the school finance equalization, originally imposed by the courts but followed by many state legislatures, and third, local governments in many states have been given a wider range of revenue authority, including sales and income taxes. One of the most thorough analyses concludes that those states which provided local governments with more revenue sources also provide lower levels of state financial aid[4]. In addition, where aid is provided to large cities it was most closely correlated with the number of poor individuals although political influence and seniority by the state's representatives and senators also helps.

These finance-specific trends, TELs, school finance equalization, and more revenue sources, have been accompanied with the continuation of the long term trend of decentralization of economic activity within metropolitan areas whereby suburbs have increased their share of business and industrial activity and those cities that have not maintained desirable conditions for residents (public safety and education appear most important) have lost both residents and business activity. Central city interests in American cities have convinced the national government to provide funds[5] for city projects to counter these trends and prevent the relative decline of central city property values. In none of the cities has a reversal of deconcentration resulted, but those cities that have maintained a desirable residential environment (in contrast to projects not oriented toward city residents) have maintained or increased population but still lost a share of business activity[6]. In the United States it is sometimes difficult to distinguish between

---

[4]ACIR, *Local Revenue Diversification: Local Sales Taxes*. August 1988.

[5]National government grants are generally less than 5 percent of total local government revenues but are a much larger percentage of own-source revenues (which may include large user charge and utility revenues) and even a larger percentage of own-source taxation. Different organizations use different bases for their comparisons and one must be careful as to what definition is being used.

[6]These trends were first identified in Adna Ferrin Weber's *The Growth of Cities in the Nineteenth Century: A Study in Statistics* , originally published in 1899 Cornell University Press, 1967). Historically, in U.S. urban areas deconcentration began when a city reached about 50,000

local government finance problems and attempts by city governments on behalf of central city property owners to maintain or enhance central city property values in the face of long term trends toward the deconcentration of economic activity in metropolitan regions. Awareness of these different objectives is important when moving on to the requests for national government funds from some of the national associations of local government.

Each of the major local government finance trends will be examined, including perspectives from state commissions that have examined the issues, the Advisory Commission on Intergovernmental Relations, think tanks such as the Lincoln Foundation which focus on issues surrounding property taxation and academic research. This material is treated together because there is a great deal of research and the conclusions reached are very similar. This seems to be because state sponsored commissions include members with a variety of perspectives and they often use research staffs that also review academic research. A final note will briefly describe some general aspects national government grant programs. The last detailed catalogue of such programs the author is familiar with was over 500 pages long.

Tax and Expenditure Limits (TELs)[7]

While Proposition 13 in California was the first widely publicized TEL in 1978, many states had TELs on their local governments prior to Proposition 13. What was different about Proposition 13 was that it was accomplished by a statewide referenda and it was quite severe. The limit put on property taxation was 1 percent of market value, but some additional conditions meant that the actual revenue collected by local governments was less than that. This limit has reduced property tax revenue to about 7 percent of total city revenues (the Census indicates 15% of own-source revenue) and there is virtually no flexibility in revenues for general governments. California appears to have the most severe property tax TEL.

---

population, although changing transportation technology also had a significant influence, and with the exception of the elevator, facilitated deconcentration. For an analysis of long run spatial patterns and trends in metropolitan areas see Robert L. Bish and Hugh O. Nourse, *Urban Economics and Policy Analysis,* McGraw-Hill, 1975, especially chapters on urbanization, location and growth, urban land use, transportation and the future. The deconcentration trend has continued with the addition of more well defined small concentrated sub-areas within large metropolitan areas. There are Canadian and U.S. central cities which are retaining or even slightly increasing in population, but they still are becoming a smaller proportion of the population in the metropolitan area.

[7]One of the last ACIR reports is its *Tax and Expenditure Limits on Local Governments* co-published by ACIR and the Center for Urban Policy and the Environment at Indiana University.

As of 1995 when the Advisory Commission on Intergovernmental Relations (*Tax and Expenditure Limits on Local Governments*, 1995) examined TELs, 46 of the 50 states had some kind of TEL on local governments. Kinds of TELs include overall property tax limits applying to all local governments, specific property tax rate limits applying to a specific kind of local government, property tax levy (revenue) limits, limits on revenue or expenditure increases, limits on assessment increases, and full disclosure requirements such as public hearings prior to tax increases. In some states TEL limits could be overcome through referenda or by using a special district or special benefiting area. The trend toward the use of special districts and special benefiting areas within counties, however, predates TEL's and reflects the trend toward a benefits-received approach to local government financing, especially within the larger western counties (many western counties are geographically larger than eastern states).

With such a variety of kinds of TELs, consequences can differ for different local governments. Two kinds of observations can be made: what has happened to total local government taxing and spending levels, and second, what else has happened.

Aggregate tax and expenditure data is influenced by many things, but overall trends for general local governments is that spending did decline slowly through the mid-1980's, and then turned upward again. The general conclusion is that TELs impacts were much more important for changes in the composition of revenue sources and on decision-making than on total expenditures for local governments.

Considerable effort has been devoted to identifying the consequences of TELs. The ACIR's general conclusion are that TELs have reduced reliance on the property tax and on taxes for own-source revenue. Secondly, there has been increased reliance on state aid, especially for education and highways, and TELs have led to greater use of fees and revenue sources such as income taxes, business taxes and sales taxes. One very important observation is that TELs may be leading to the creation of a more centralized public sector that is less responsive to local preferences. This latter point is very important as it is a major conclusion of the California Speaker's (Speaker of the House) Commission on State/Local Government Finance (www.speaker.metroforum.org) where they conclude that tax rate limits in California have eliminated the ability of the counties and cities to move tax rates up or down in their annual budgeting process so that all adjustments must be made on the expenditure side. The same conclusion has been reached by the Institute of Local Self Government in their *Fiscal Condition of California Cities 2001* report (www.ilsg.org), by the League of California Cities (www.cacities.org) and by Professor Chapman, formerly of the University of Southern

California[8]. This criticism has arisen elsewhere as well, but few other states have as severe tax rate limits, as does California. The consensus of local governments and academics in California is that the property tax should be returned to its historical role whereby city or county councils set annual tax rates in their annual budgeting process where they compare citizens demands for services with the taxes imposed to raise the necessary revenue. This would not preclude continuing to use the sales tax[9] or receive state grants, but it would give the local governments back a revenue source where local officials can balance costs and benefits in their decision-making.

The State of Minnesota has less severe limits than California but their Governor's budget recommendations (http://morefinance.st.mn.us) are similar to those in California: return the property tax to local governments so that local governments can make their own expenditure decisions. They emphasize revenue flexibility and accountability to local taxpayers. The committee also recommends ending unfunded mandates and removing school financing of basic K-12 education from the property tax while allowing voter approved add-ons on the residential property tax in local school districts.

Most of the research on TEL's has been done during the longest period of sustained economic growth in the U.S. Because revenue from sales and income taxes grow proportionally more than the growth rate, this growth hid problems with TEL's that have emerged during the recent downturn. It is that in an economic recession, revenues from sales and income taxes also decline more than the decline in the economy and this has caused some recent serious fiscal problems in cities dependent on these revenue sources.[10] For an example of a sales tax city see "Seattle's latest economic forecasts bolster Mayor Greg Nickels' call to get city finances under control: Drops in revenue, employment worse than area has seen in 20 years," City of Seattle news release 6/3/2002. While the national and state governments can incur operating deficits in a downturn to maintain programs, most local governments are not allowed to have operating

---

[8]*The Continuing Redistribution of Fiscal Stress: The Long Run Consequences of Proposition 13*. Lincoln Institute Working Papers, 1988 (www.lincolninst.edu).

[9]As will be seen when examining local government sales taxes, they are generally imposed over wide areas, including entire states, at the same rate and this cannot be adjusted during the annual budgeting process.

[10]New York City, which has a high local government income tax and faces the consequences of September 11 faces severe problems. Lesser, but significant problems face other jurisdictions relying on income taxes and sales taxes, *New York Times* April 25, A. p. 30.

deficits and for those where operating deficits are allowed they are quite limited. This has required some serious expenditure cuts in some local governments. Those relying on property taxes, in contrast, have a much more stable revenue source[11].

School Finance Equalization

Historically, in most states K-12 education was run by locally elected school boards in school districts and their financing came from property taxes they levied even though the taxes were collected by the city or county tax collector. Even when state grants provided some support, the different levels of assessed value per student in different school districts led to different levels of spending per student in the different districts.[12]

---

[11]The stability of the property tax as a revenue source results from the way it is administered even when assessments are not kept up to date. This is because governments use the tax to balance their budgets with a focus on whether or not there will be an increase in the actual amount billed**,** not the property tax rates. In contrast, the focus on sales and income taxes is on rates. For a discussion of revenue elasticity (the rate at which tax revenues grow relative to growth of the economy) see Bish and Nourse, Ch. 6.

[12]About one half of the property tax base is non-residential, i.e. business, industry, agricultural or forests. In those school districts with a higher than average concentration of non-residential properties, parents could achieve greater spending on schools with most of the cost borne by the non-residential properties and at very low costs to themselves. In contrast, in school districts where there was little non-residential property school expenditures bore heavily on the residents and they tended to spend less on education. Thus, the variation in assessed value per student attributable to different amounts of non-residential properties led to very different expenditure levels in different school districts.

In a court case in California, *Seranno v. Priest*, in 1971, the court ruled that different per student spending in different school districts was ruled unconstitutional if the cause was unequal wealth among school districts because schooling was deemed to be a fundamental interest. Since *Serrano v. Priest* there has been a significant movement among U.S. states to try to remove the influence of different levels of assessed value upon which property taxes are based from influencing the per student expenditures on K-12 education. For a discussion of legal issues see A discussion of the legal issues and actual results of the decision are described in Robert L. Bish, "Fiscal Equalization Through Court Decisions: Policy Making Without Evidence," in *The Delivery of Urban Services: Outcomes of Change* ed. Elinor Ostrom, Sage Urban Affairs Annual Reviews Vol. 10, 1976. While the advocates of equalization focused on "poor" students, there is no correlation between low assessed value per student and students from low-income families. This is because many students from low-income families live in cities or rural areas with very large non- residential tax bases and many students of higher income families reside in suburbs with very little non-residential tax base. Suburbanites living in areas with no non-residential tax base were the major beneficiaries of the decision.

State governments responded to the unfairness of the situation by increasing "equalization" grants and consolidating school districts. By consolidating school districts each district's per student-assessed value was closer to the statewide average. In spite of grants and consolidations considerable per student spending differences continued to exist in most states because local school boards still controlled their own budgets and property tax rates. Attempts to achieve greater equalization in school financing have continued.

The net result of equalization attempts has been extensive centralization of school finance to the state government level. The same issues and results have occurred in both Alberta and British Columbia, although in Canada the process was not court driven.

Three findings on school finance reform are interesting[13]. First, there has been continued reliance on property taxation but greater equalization within public school systems. Two other findings are also important. Centralization of school financing is correlated with a decline in student test scores; not just of the college bound such as the SAT, but also scores on the Armed Forces Qualifying test and the National Assessment of Educational Progress. Second, centralized financing is associated with non-parent loss of interest in the local schools. What is interesting is that research, including survey research of voters on school finance issues, indicates that non-parents understood that high quality schools in their neighbourhood raised the value of their property and they paid attention to the quality of their local schools and often voted in favour of additional school funding for that reason. Once local voter discretion over local school funding was eliminated the non-parents simply lost interest[14].

While school finance is not the focus of this report it is important to recognize that school finance researchers have identified serious problems associated with local school board loss of control over both the expenditure and revenue sides of their budget. These problems are very similar to those identified where TEL's had also restricted local government control over their revenues.

---

[13]An up to date summary of school finance related research is contained in William Fischel, *The Homevoter Hypothesis*, Harvard University Press, Ch's. 5 and 6.

[14]One researcher goes on to conclude that when financing decisions move to the state level education funding is likely to decline because only about 25% of voters have children in school and they can be ignored in a way that local school boards could not ignore their voters when non-parents also wanted high quality schools, although for different reasons than parents.

Alternative Revenue Sources

One of the most important trends in the U.S. has been the broadening of revenue sources available to general local governments. As of 1996, 39 states allowed local government use of general sales taxes and 29 states, income taxes. Slightly more states allowed the use of sales taxes by counties than by their cities and income tax use was limited to use by cities in all but three states. All general local governments also retain use of the property tax. Research findings on each major revenue source will be described in turn. The descriptions will be brief; focusing on consequences of their use that appear to have been unanticipated.

Sales Taxes. The most wide spread new revenue source for local governments in the United States is the retail sales tax. Most are administered as part of the state sales tax collection system and most revenue is returned to the local government where the revenue originates. A few states have systems where revenue is counted as being collected over a wider area, usually a county, and returned to municipalities on a per capita rather than origin basis. Four problems with local sales taxes have been specifically identified.

First, origin based sales tax revenue exacerbates inequalities in local government finance. This is because in many areas retailing is concentrated in some municipalities relative to the distribution of population. This concentration and the resulting inequalities are greater than the concentration of assessment base for property taxes.

Second, the potential to obtain sales tax revenue has led to major competition among municipalities to develop new retail shopping centres with the consequence being more shopping malls in the region than could be supported by residents. Cases were identified where rezoning for light manufacturing was rejected in favour of rezoning for a shopping center because the additional revenue from the sales tax and property tax would outweigh the property tax revenue from industry. Competition for retailing just moves retailing around within the urban area; new industries add to the economic base.

Third, during the 1990's economic expansion, reliance on sales taxes was desirable as revenues increased more rapidly than the costs of providing services. However, the economic downturn of 2001-2002 has led to significantly reduced sales tax revenues and created serious financial problems for some local governments, especially those where TELs had limited tax rate increases on other taxes.

And, finally, local officials regard Internet sales as a threat to the retail sales tax as a revenue source. Current tax law in the U.S. requires vendors to collect the state and local sales

tax only for jurisdictions where the company maintains a physical presence. While states utilizing sales taxes have a comparable "use tax", which makes the equivalent tax payable on goods purchased out of jurisdiction, there is no practical enforcement as local citizens are not known to run down to the tax collection office to pay use taxes on goods they purchased elsewhere. While catalogue sales could cause a similar problem, historically the largest catalogue sellers such as Sears also had retail outlets in every state so sales tax avoidance was not a problem. However, Internet sales are regarded as potentially being a significant problem because the volume of purchases from out of jurisdiction sellers is anticipated to increase. This issue is not one local governments can deal with by themselves.

Local Government Income Taxes. Local government income taxes are used in 29 states, but except for Pennsylvania, Maryland and Ohio they are used only by the largest cities. This use is also pretty much confined to the northeastern part of the mid-west and northeastern United States. While some piggyback on state tax administration and use state determined measures of income, most levy locally administered taxes on gross income of employees in the jurisdiction or gross payrolls of businesses. This captures taxes from non-residents who work in the city but live elsewhere.

Several issues arise with local income taxes, the most important of which are tax differentials from neighbouring jurisdictions and even more extreme revenue fluctuations than with sales taxes. One study concluded that Philadelphia's 4.96% income tax rate had cost the city approximately 100,000 jobs to the suburbs[15]. Other studies indicate that the anticipated burden of a local income tax different from taxes in adjacent jurisdictions is capitalized into land values at a higher rate than property taxes[16].

During the 1990's economic expansion cities using income taxes were happy with the revenue gains from the growing economy without having to raise tax rates. With the recession in 2001-2002, the reverse is true. Cities where the income tax is their largest revenue source are facing significant declines in revenue and do not want to raise tax rates to overcome the revenue loss in a recession.

---

[15]Reported in ACIR, *Local Revenue Diversification*: *Local Income Taxes*, August 1988.

[16]Property taxes are generally capitalized into land values, that is property value is reduced the higher the property tax. These reductions are offset by the benefits provided to the property and its users by the local services provided. The depressing effect of local income taxes is greater for the same number of dollars in taxes (Helen F. Ladd and Katherine L. Brady, "City Taxes and Property Tax Bases," *National Tax Journal*, December, 1988.

While none of the research identified the issue of unequal tax bases creating greater fiscal inequality, this is most likely because there is widespread use in only two states. One would expect, however, that the tax base, especially if levied at the place of employment is very unequally distributed among local go vernments relative to population, perhaps more so than the distribution of retail sales, which in turn have been identified to be more unequally distributed that the assessment base for property taxes.

Property Taxation. The property tax remains the largest tax source, and for most non-school general local governments, the largest single revenue source. The exceptions are those few cities that obtain more revenue from an income tax and counties and some cities in California where sales tax revenues are greater. There is some reduced use of the property tax for school finance, and where it is used for school finance it is either complemented by state grants or some funds taken away to provide for some equalization. The most important aspect of property taxation is the change in how it has been viewed during the past 50 years. During the first half of the century the tax was viewed as a tax on wealth and the tax base included personal property (including bank account balances in some states) and issues included such things as whether the tax on real estate should be on the entire value of the property or only on the owners equity in the property. Gradually personal property was removed from the tax base and the tax base became the market value of real property (land and buildings), with some variation to include mobile homes and sometimes machinery within a plant. The quality of assessments has also been improved. As a wealth tax, if assessments were consistent, the property tax was viewed as falling more heavily on those with higher wealth, which were usually those with higher incomes as well[17].

During the 1960's the property tax began to be viewed as an excise tax on housing, and because low income families spend a larger proportion of their income on housing than did higher income families the residential portion of the property tax became viewed as regressive, that is, collecting a higher percentage of income from lower income families than from high income families. With an excise tax approach it is impossible to tell how the non-residential portion of the tax is born because one would have to know whether or not the business property owners who paid the tax could pass the burden on to customers of the business, to their

---

[17] For earlier views of the property tax see Harold M. Groves and Robert L. Bish, *Financing Government*, Holt, Rinehart and Winston, 1973. The first edition of this text by Groves alone was published in 1939 and much material from earlier editions was included in later editions to provide a historical perspective. For an up to date collection that covers current views see Wallace E. Oates, *Property Taxation and Local Government Finance*, published by the Lincoln Institute of Land Policy, 2002. This volume contains articles by what most scholars would consider to be the best current local government finance economists in the United States.

employees, to a lessee, or whether the original purchase price of the property was lower because of the anticipated tax payment. No conclusions on tax incidence could be generalized from the non-residential portion of the tax.

In response to the excise view of the property tax many states created programs to reduce the burden on low-income residents or residents of the lowest valued dwellings and the elderly. Some program of this kind exists in all states. The view of the property tax as a regressive excise tax on housing consumption was popularized in the 1960's. It was, however, immediately challenged by economists on both theoretical and empirical grounds. The present consensus is that the excise tax view is simply wrong and not empirically verified, but the view persists among the public and the occasional scholar from another field who has reason to write about property taxation in another context[18].

Three compatible views have come to be accepted among property tax and local public finance scholars. First, called the "new" view, is that if property taxes are levied over large areas like provinces and countries, they operate to reduce the return on investment in property so that the after-tax return on property investments is the same as equivalent risk investments in other assets. The net effect depends on how other assets are treated for taxation. This view is not very useful for examining local government property taxation.

The second view, with a focus on local government usage, is that property taxes are fully "capitalized" into the market value of property. This means that the anticipated property tax payments are taken into account when purchasing a property, and thus tax burdens to current owners occur only from unanticipated changes after they become the owner. This means the burden or benefit of an unanticipated rise or fall in taxes accrues to the current owners. Subsequent owners will have taken those changes into account when they purchase the property. This means that changes in property tax levels accrue to the property owners at the time of the change. They cannot be passed on to others and they are not spread out beyond the jurisdiction's boundaries. It is the theory and evidence on "capitalization" that leads to the "benefit" view of the property tax.

The "benefit" view is applied when the local property tax is used to provide local public services to benefit local people and users of property. Local public services, when provided to

---

[18]An example is an excellent book on regional governance by top political scientists who are simply about 20 years out of date in their understanding of the a property tax. G. Ross Stephens and Nelson Wikstrom, *Metropolitan Government and Governance,* Oxford University Press, 2000.

people and users of property raise the market value of the property and will be taken into account by property purchasers. Thus, while the tax is capitalized as a burden, the benefits of the services are capitalized as a benefit. **Most important, if the local government is acting efficiently the benefits of the public services will raise the value of the property a greater amount than the taxes decrease it.** This is why in virtually all areas served by local government property provided with public services is worth much more than unserviced property outside the local government boundaries. Most local governments simply do provide more benefits than costs. It is recognition of the capitalization of both property taxes and benefits of local services that makes the property tax the fair and appropriate tax for local governments[19].

The benefit view of property taxation depends on jurisdictions being small enough (including separate tax-benefiting areas within larger governments for activities that are different) so that differences in benefits between jurisdictions can be perceived. This occurs most strongly where there are a multiplicity of small governments that can respond to the preferences of their citizens[20]. It does not mean that local governments cannot have other revenue sources, but it means that the other sources (except for individual user charges for specific services) should be fairly constant and it is property tax rates that should be increased or decreased annually to balance the budget at the margin. When local governing councils, both municipal and school, set the annual tax rates citizens pay, much closer attention to them than when they are funded with “other people’s money”.

It should be noted that the benefits view of the property tax does not apply to the funding of programs specifically designed to redistribute income such as welfare. Funding welfare with the local property tax would be expected to depress property values and any increases would be limited to apartments or that part of the housing market occupied by welfare recipients. Funding welfare through local property taxes provides perverse incentives to local government councilors[21].

---

[19]In addition to his essay in the Lincoln Institute volume, William Fischel’s *The Homevoter Hypothesis*, Harvard University Press, 2001 summarizes the evidence which supports this conclusion. Chapters 5 and 6 also cover school finance.

[20]Differences in costs and performance of metropolitan areas consisting of many local governments compared to amalgamated governments are reviewed in Bish, 1999.

[21]This issue has been well understood since the 1970's (See Robert L. Bish, *The Public Economy of Metropolitan Areas*, Markham/Rand McNally 1971, for example) and virtually all states provide welfare at least the county, not municipal level, and it is largely funded by state grants. Those cities where welfare is a large expenditure is primarily cities which simultaneously perform county functions, including San Francisco, New York City, Indianapolis and other consolidated county-cities.

The rejection of the view of property taxes as just an excise tax on housing and view of property taxes as capitalized into property values, which for local taxes may be more than offset by the capitalization of local service benefits into capital values, has itself led to conclusions that the property tax is the most appropriate tax for municipalities. Recent research on the importance of having a direct tie between voters and the council members who make decisions on both taxes and expenditures strengthens the case for property taxation at the local level because it is the easiest tax to administer with varying rates among jurisdictions and from year to year. This perspective reflects major research on the roll of the property tax in the United States and it has taken about 30 years to emerge in the local public finance community. It may take another generation for the general public although the survey research on school finance referenda voting indicates that many citizens intuitively understand the nature of this tax.

CONCLUSIONS

Local governments in some states have access to a wide range of revenue sources. The move to income and sales taxes has introduced greater cyclical fluctuations in local revenues. At the same time TEL's have restricted their ability to respond to needs for additional revenues. When combined with nearly universal requirements that local governments not incur operating deficits, economic downturns can require service cutbacks. This fiscal rigidity is likely to be the focus of local government financial reform over the next several years, especially if there is not a quick recovery in revenues from the recent recession.

REFERENCES

Advisory Commission on Intergovernmental Relations. *Local Revenue Diversification: Local Sales Taxes*. Washington, D.C.: 1989.
.

_________ . *Local Revenue Diversification*: *Local Income Taxes.* Washington, D.C.: 1988.

_________ . *Significant Features of Fiscal Federalism: 1989 Edition*. Washington, D.C.: 1989.

_________ . *Tax and Expenditure Limits on Local Governments*, Washington, D.C.: 1995.

Atkins, Pat, John Dewitt and Jennifer Thangavelu. *The Emerging Regional Governance Network*. Washington D.C.: The National Association of Regional Councils and the National Institute of Public Information, 1999.

Bish, Robert L. "Fiscal Equalization Through Court Decisions: Policy Making Without Evidence," in *The Delivery of Urban Services: Outcomes of Change* ed. Elinor Ostrom. Sage Urban Affairs Annual Reviews Vol. 10, 1976.

__________. *Local Government Amalgamations*. C D Howe Institute, 2001.(www.cdhowe.org)

__________. *The Public Economy of Metropolitan Areas*. Markham/Rand McNally, 1971.

__________ and Hugh O. Nourse, *Urban Economics and Policy Analysis.* McGraw-Hill, 1975, Ch. 6.

Chapman, Jeffrey, *The Continuing Redistribution of Fiscal Stress: The Long Run Consequences of Proposition 13*. Lincoln Institute Working Papers, 1988, (www.lincolninst.edu).

Cowan, Dawn and Tanis Janes Salant. *County Charter Government in the West*. The University of Arizona in cooperation with NACO, 1999.

Fischel, William. *The Homevoter Hypothesis.* Harvard University Press, 2001.

Groves, Harold M. and Robert L. Bish, *Financing Government*. Holt, Rinehart and Winston, 1973.

Ladd, Helen F. and Katherine L. Brady. "City Taxes and Property Tax Bases," *National Tax Journal*, December, 1988.

League of California Cities. *Financing Cities: A Status Report on California cities and the Need for Serious Reform*. Presented to the Commission on Local Governance for the 21st Century. April 30, 1999.

New York Times April 25, A. p. 30.

Oates, Wallace E., ed. *Property Taxation and Local Government Finance.* Lincoln Institute of Land Policy, 2001.

Ostrom, Vincent, Robert L. Bish and Elinor Ostrom. *Local Government in the United States*. Institute for Contemporary Studies, San Francisco, 1988.

Stephens, G. Ross and Nelson Wikstrom. *Metropolitan Government and Governance.* Oxford University Press, 2000.

U.S. Census Bureau. *Government Finances 1998-99*. Washington, D.C.: 2001.

Weber, Adna Ferrin, *The Growth of Cities in the Nineteenth Century: A Study in Statistics.* originally published in 1899, Cornell University Press, 1967.

ABOUT THE AUTHOR

Dr. Bish earned his Ph.D. in Economics from Indiana University in 1968 and served in departments or schools of economics, public affairs, public administration and urban studies at the universities of Washington, Southern California and Maryland before joining the School of Public Administration at the University of Victoria in 1981. Dr. Bish has researched, consulted and published on local government in both the U. S. and Canada. his major works include *The Public Economy of Metropolitan Areas* (1971); *Understanding Urban Government: Metropolitan Reform Reconsidered* (1973) with Vincent Ostrom; *Financing Government* (1973) with Harold Groves; *Urban Economics and Policy Analysis* (1975) with Hugh O. Nourse; *Local Government in the United States* (1988) with Vincent and Elinor Ostrom, *Indian Government: Its Meaning in Practice* (1989) with Frank Cassidy and *Local Government in British Columbia* (1987, 1990, 1999). In 1999 Dr. Bish was commissioned by the British Columbia Ministry of Municipal Affairs to review of British Columbia's regional district system, *Regional District Review-1999: Issues and Interjurisdictional Comparisons,* and the C.D. Howe institute recently published his review of evidence on amalgamations in North America in *Local Government Amalgamations: Discredited Nineteenth-Century Ideals Alive in the Twenty-First.* . Dr. Bish is one of 19 economists in Canada included in the *Who's Who in Economics*, where selection for inclusion is based on the number of times an economist's work is cited by other scholars in academic work

June 29, 2002.