Devolution, Fiscal Federalism, and Changing Patterns of Municipal Revenues: The Mismatch between Theory and Reality

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Devolution, Fiscal Federalism, and Changing Patterns of Municipal Revenues: The Mismatch between Theory and Reality

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ABSTRACT

Theories of fiscal federalism, such as those propounded by Musgrave, Tiebout, and Brennan and Buchanan, prescribe assignment of revenue sources among federal, state, and local governments. In this article, we demonstrate that the recent diversification of municipal revenue sources in response to devolutionary forces does not follow the expectations of the fiscal federalism theories. Our analysis suggests that the use of an institutional approach to the study of fiscal federalism would help to reduce the mismatch between theory and reality.

In an essay entitled ‘The New American Devolution: Problems and Prospects,’ Max Sawicky observes that “if we exclude Social Security, Medicare, net interest on the federal debt, and defense from the total expenditures of federal, state, and local governments in the United States, 80 percent of what remains is administered by state and local governments’ (1999, 3). He goes on to proclaim, “Therefore, it can be said that the bulk of national domestic policy is already decentralized or ‘devolved’” (1999, 5). Devolution, however, did not stop at state capitals; a ‘second order’ of devolution pushed responsibilities to the lower rungs on the federal ladder. States have been forced to downsize, streamline, and restructure (Cigler 1998, 63–64) and in the process have “often shifted burdens to local governments without careful consideration whether this was the correct course” (Gold and Wallin 1999, 73).

Devolution between the states and their subnational units of government has been largely ignored in studies of contemporary intergovernmental relations (Nathan 1996; Weber and Brace 1999). The theoretical rationale for the policy of devolution flows in part from the logic of economic models of federalism. These models derive quite specific prescriptions for the assignment of functions and revenue sources to levels of government. But the reality of ‘second-order’ devolution runs counter to the predictions of the economic models. This essay explores this paradox and suggests that institutional approaches offer an alternative to the reigning theories of fiscal federalism. It does so by examining recent shifts in the sources of municipal revenues. These empirical realities are used to critically discuss the explanatory applicability of models of fiscal federalism to devolution.
The analysis begins with a brief account of devolution within the context of state–local relations. This is followed by a survey of the principal models of fiscal federalism, with the express purpose of identifying propositions that could be used to explain changes in local revenue sources in the face of devolution. Next, the shifts in the revenue sources relied on by municipal governments are profiled and compared with the predictions of existing theories. Finally, the paradox between the widely held models of fiscal federalism and the changes in municipal revenue sources is discussed. Because the economic models of fiscal federalism yield a set of inconsistent propositions as to how state–local relations would be altered by devolution, the analysis concludes by suggesting the utility of an institutional approach.

CRITICAL TRENDS IN STATE–LOCAL RELATIONS

State–local relations are the nation’s oldest intergovernmental relationship (Walker 1995, 267). Thrust and counterthrust by the two tiers of government have continued unabated since the colonial period, and it is no surprise that substantial change has occurred in the nature and position of state and local governments (Krane, Rigos, and Hill 2001, 7–14). The reform of state governments beginning in the 1970s was one of the most important institutional transformations that affected state–local relations after World War II (Bowman and Kearney 1986; Reeves 1982). The resulting institutional and structural changes closed the gap in capacity and competence that had existed previously between municipalities and states. But alterations in the state–local relationship did not stop at this point. Weber and Brace assert that ‘over the past three decades, states and localities in the United States have been changed dramatically in function and performance’ (1999, 1). In particular, they (1999, 2–16) identify important shifts in the larger context of federalism, the finances of state and local governments, and increased opportunities for citizens to participate in state and local policy processes. For the purpose of this analysis, it is useful to focus on two specific aspects of these recent changes in state–local relations: (1) the larger context of federalism, especially the movement toward devolution, and (2) the intergovernmental structure of revenues.

Devolution

Alterations in state–local relations are naturally affected by federal policy changes. From approximately 1960 to 1980 the national government engaged in an unprecedented outpouring of financial aid to states and localities, primarily targeted toward physical infrastructure projects to reverse the deterioration of many metropolitan areas, improve the nation’s transportation network, and protect the environment. This period of federal fiscal expansiveness was also marked by the beginnings of national subsidization of social services that had been funded principally by state and local governments. These latter actions were part of the larger effort to end racial and gender discrimination, uplift the poor, and insure health care for the elderly and the disabled. One of the fundamental consequences of the national government moving to finance social services was that in a very few years aid to persons began to exceed aid to places, and this trend has not been reversed since (Kincaid 1999). Federal aid as a percentage of state/local outlays reached its peak in 1978 and began a downward slide, so although ‘in 1980 federal grants-in-aid accounted for 26.5 percent of spending by states and localities, in 1987 it was 19.1 percent … [that is] federal dollars spent on grants-in-aid for ‘governing’ functions declined 34...
percent in real terms between 1980 and 1987’’ (Gleason 1988, 10). Cuciti (1990, 235–50) estimates that federal aid to urban places declined by 47 percent from 1980 to 1987, while all other federal grants and transfers grew by 47 percent.

This swift turnaround signaled the end of expanding federal aid to states and localities and confirmed the movement toward devolution that had begun in the late 1960s. Beginning with the use of block grants and the Nixon administration’s policy to transfer some functions back to the states and to return more program implementation responsibility to states and localities, the movement away from program control by Washington gathered speed. Deregulatory initiatives during the Carter administration were followed by the Reagan administration’s rejection of (1) the reliance on national dollars by the New Deal and the Great Society to foster change and (2) a role for the national government in most domestic functions (Krane 1990, 108).

Much of the intellectual and philosophical impetus behind devolution rests on the utopian quest for balancing up functions with the federal divisions of American government (Nathan and Doolittle 1987, 6). Debate among scholars over just how much devolution has occurred continues (see, for example, Dilger 2000), but it is clear that ‘‘the intent of devolution is to enhance the responsiveness and efficiency of the federal system based on the theory that state and local governments can do a better job of providing services for citizens’’ (Watson and Gold 1997, 1). It is equally clear that ‘‘federal assistance to cities is much diminished since the late 1970s’’ and ‘‘a much smaller portion of federal aid is devoted to urban programs than was true just a decade and a half ago’’ (Eisinger 1998, 310–11). By 2000, federal aid to local governments constituted only 3.7 percent of total general revenues (Bureau of the Census 2001). The product of the devolutionary shift to the states of a larger share of the fiscal and administrative responsibility for social assistance programs is a condition best labeled by John Shannon, who termed it ‘‘fend-for-yourselffederalism’’ (1987, 34).

While federal dollars to states and localities grew proportionally smaller, federal conditions on aid and unfunded federal mandates continued to grow larger. The realities of ‘‘fend-for-yourselffederalism’’ forced state governments to engage in their own devolutionary actions and push program responsibility to local governments (Walters 1996). Watson and Gold determined that devolution from state to local governments began in the mid-1980s: ‘‘This devolution is reflected in the relatively slow growth of state financial aid to local governments, which is one of the reasons local taxes have been rising faster than state taxes almost continuously since 1985’’ (1997, 2). They also stated that this period can be characterized ‘‘as de facto devolution because most of the changes occurred implicitly, as states assigned a low priority to helping local governments because of state budget pressures and became more willing to allow localities to handle their own problems without state interference’’ (1997, 2). This ‘second-order’ devolution, according to the National League of Cities, has meant that ‘‘transfers of program responsibilities from state and federal government, as well as the imposition of state and federal mandates, increase the roles and responsibilities of municipal governments, often without corresponding fiscal capacity or authority’’ (2003).

Vertical Fiscal Relations

The revenue side of the ledger is politically more interesting because it has become the fiercest policy battleground of state–local relations. Beginning in the mid-1950s state
governments experienced a significant increase in “own-source” revenue as a proportion of total revenues, such that state own-source revenues “vastly outpace[d] federal contributions to average state revenues” (Weber and Brace 1999, 5). This revenue growth allowed states to increase aid to localities for over two decades, but this aid peaked in 1980 and began to decline (Brizius 1989, 61). Although state aid to local governments in dollar amounts continued to increase from $83 billion in 1980 to $288 billion in 2000, as a proportion of total state spending it decreased from approximately 33 percent in the late 1970s to approximately 24.3 percent in 2000 (Berman 1998, 68; Bureau of the Census 2001). The result was that state aid to local governments did not keep pace with the functional responsibilities state governments had devolved to local governments (McCue 1993). State aid to local governments equaled $195.8 billion in 1991 and constituted 29.9 percent of local government spending (Bureau of the Census 1992). Although the dollar amount of state aid to local governments increased to $288.3 billion in 2000, it dropped to 26.9 percent of local government spending (Bureau of the Census 2001). Expressed differently, state aid to local governments through the 1990s increased by $92.5 billion, or 47.2 percent, but this increase did not match the $415 billion, or 63.3 percent, increase in local government spending. The unpleasant result for local officials was a double whammy—not only had federal aid essentially dried up, but state aid also was eroding. If local governments are the “workhorses” of American federalism, then “second-order” devolution piled more work on the horse but gave it less to eat.

DEVOLUTION AND THEORIES OF FISCAL FEDERALISM

The changes in state–local relations reviewed briefly in the previous section produced a situation that “involves operating in an increasingly resource-constrained environment in which national government transfers are being reduced, state responsibilities are increasing, and the political costs of state tax increases appear to be high” (Weber and Brace 1999, 11). But how would states and localities respond to this situation given that their options were limited and unpalatable? How would state–local relations, especially fiscal relations, change? If there is one component of the literature on federalism that is theoretically developed and has been subjected to analytic tests, it is fiscal federalism (Krane 1998, 871). Do the predictions of this body of theory and research address the types of fiscal change that occurred as a consequence of devolution such as the changes in tax assignment one might expect as a result of “second-order” devolution? In particular, does the compass of fiscal federalism point to a preferred revenue option for municipal officials as they attempt to navigate the sea changes of devolution?

Musgrave’s Principles of Functional Assignment

A natural starting point for any discussion of fiscal relations among governments is Richard Musgrave’s recommended division of fiscal functions, wherein he stated: “The heart of fiscal federalism thus lies in the proposition that the policies of the Allocation Branch should be permitted to differ between states, depending on the preferences of their citizens. The objectives of the Distribution and Stabilization Branches, however, require primary responsibility at the central level” (1959, 179–83, quoted in Oates 1994, 128). Musgrave proposed four basic principles for tax assignment: (1) highly progressive taxes, especially for redistributive purposes, should be centralized; (2) in general, lower-level
governments should eschew taxes (at least nonbenefit taxes) on highly mobile tax bases; (3) the central government should exercise primary taxing authority over those tax bases that are distributed across jurisdictions in a highly unequal fashion; and (4) although user taxes and fees have much to commend them at all levels of government as benefit taxes, they are an especially appealing revenue instrument at the most decentralized levels of government (Oates 1994, 131).

Though research generally confirms Musgrave’s ideas about stabilization and redistribution, the existing research is much less clear about his principles for the allocation of functions of government and, in particular, the vertical structure of revenue systems. Central governments in many countries, as expected, are the prime users of income taxes, and local governments around the world have historically relied on property taxes. But considerable variation exists, and there is not a direct congruence between Musgrave’s normative prescription and empirical realities (see Bahl 1994). Just to note the U.S. case, local government adoption and use of income taxes go back to 1938; today thirteen states now permit local governments to tax income, and, as a proportion of local government revenues, income taxes have slowly but steadily grown and show every indication of steady future increases. Research by Goodspeed (1989) finds that local governments can use income taxes with only small losses of efficiency, thus contradicting Musgrave’s prescription. One reason for this small loss of efficiency is simply that local governments typically rely on state governments to collect income (and sales) taxes for them.

Tiebout Hypothesis and the Theory of Competitive Federalism

Perhaps the most widely known and cited description of allocation decisions made by decentralized governments is Charles Tiebout’s 1956 model of interlocal competition. Using the assumption that municipal officials compete for citizens and the taxes they pay by manipulating the level, mix, and quality of public goods and services offered by the jurisdiction, Tiebout argued that citizens ‘shop’ among cities for a preferred combination of public goods and taxes. Tiebout argued that, just as citizens exercise mobility to shop for private goods and services, they would also shop for public ones. ‘Shopping’ among cities is possible if citizens possess spatial mobility and numerous local governments exist. If taxes reflect the marginal cost of city services, then according to Tiebout the outcome could be as efficient as private sector allocation. Because citizens can ‘vote with their feet,’ Tiebout believed that local officials would keep taxes as low as possible while still offering attractive city services.

Tiebout’s market model of local governments did not address vertical intergovernmental relations, but Paul Peterson did in his influential book City Limits (1981), where he proposed a new theory of competitive federalism built explicitly from Tiebout’s ideas. A full treatment of Peterson would require several pages; it is sufficient here to note a few important propositions from Peterson’s model. He assumed that local officials approach decisions about budgeting with a strategic eye toward the economic interests of the city and rely on a benefit/cost calculus. In doing so, city officials consider a taxpayer’s proportional contribution to the local budget as well as the direct and indirect incidence of any taxes they levy. Therefore, ‘in order to protect the economic well-being of the community, the government must maximize the benefit/tax ratio for the above average taxpayer’ (Peterson 1981, 71). Or more simply, the competitive market among local governments creates pressures pushing cities toward allocation policies and away from redistributive policies.
From an intergovernmental perspective, Peterson (1981, 82) considered this local calculus as an explanation for vertical cooperation on developmental policies (i.e., fostering economic growth) and vertical conflict over redistributive programs. Thus, he arrived at the same recommendation for a functional assignment of responsibilities that Musgrave did.

A key element in Peterson’s model is the relationship between taxpayers and officials, and as part of that discussion, Peterson (1981, 74) offered some important statements about local revenues. First, he noted that the local property tax is important as the significant source of local revenues. Next, he briefly reviewed the usual criticism of the property tax that it (1) is income inelastic, (2) is a surcharge on a particular type of economic good, and (3) burdens low-income groups disproportionately. He then critiqued the countercriticism of those analysts who defend the property tax and concluded by noting that, this debate notwithstanding, ‘local governments continue to prefer it over the income or sales tax, simply because it is a tax on those products least equipped to escape its application’ (1981, 74). Peterson (1981, 72–74) argued that the disadvantages of other revenue sources to local governments strengthened the relative reliance on the property tax because (a) local user charges are limited to the cost of the service provided and are not subsidized by federal tax policy, (b) sales taxes encourage residents to purchase products outside of the jurisdiction, (c) taxes on profits earned in the locality provoke businesses to move elsewhere, and (d) local income taxes prompt residents to seek employment elsewhere.

Other scholars, principally in political science, have modified both the original Tiebout hypothesis and Peterson’s theory of competitive federalism. An important example is Schneider, who analyzed the political economy of suburban municipalities and found that although ‘growth in local property wealth is inversely related to the local tax bill … redistributive social expenditures do not deter the accumulation of local property wealth’ (1989, 172). This result runs counter to Peterson’s theory, and Schneider argues that the distribution of wealth in a community is highly stable and that ‘local fiscal and budgetary policies do not much improve a community’s welfare’ (1989, 173). Another critical finding in Schneider’s work is that ‘variation in tax price was more consistently related to smaller government than was variation in expenditures’ (1989, 204). Put another way, the package of public services provided by local governments is relatively more standardized across localities than the tax bill is. After all, most cities have to offer the same but diverse set of ‘housekeeping’ functions; what will vary is the quality of the services and thus the tax price. Schneider also provides an important analysis of intergovernmental aid and notes that it is driven by forces largely outside of local governments and that, given the decline occurring during the period of his analysis, aid ‘may ultimately produce even tighter limits on local budgets and local policy’ (1989, 195).

Although the competitive theory of federalism has exercised substantial influence on the study of local governments and intergovernmental relations, its explanatory reputation is greater than its empirical foundation. Several studies (Basolo and Huang 2001; Dowding, John, and Biggs 1994; Rusk 1995; Smith and Smyth 1996) have found various flaws in the Tiebout model and its application to local government behavior, but perhaps the most serious empirical refutation is Stein’s (1987) research using over 11,000 cities in 224 metropolitan areas. Testing the Tiebout view that cities will exhibit differentiated market baskets of goods and services, Stein discovered little differentiation and a high degree of homogeneity in service packages from city to city. Schneider’s work also produced the same result. In other research Stein (1990) offered evidence that local governments also pursue redistributive policies, contrary to the city limits thesis. He also
suggested that cities act in ways that appear to be at odds with their economic interests by adopting institutional strategies such as contracting out to constrain inefficiencies reputedly associated with redistributive policies.

As important as this debate over local services is, it does not address questions related to revenues. However, by inference one can extract a few propositions directly related to local government revenue decisions. Citizens in a Tiebout market of competitive communities ‘shop’ for a basket of goods and services that comes with a tax price. The research around the city limits model indicates that city services are relatively homogeneous, but there is some evidence that tax bills vary. The obvious explanation is that of quality of service, but Stein (1987, 155–56) discounts this explanation, as do studies of citizen satisfaction with community services (see, for example, Lowery and Lyons 1989; Lyons and Lowery 1989). Even more damning is Stein’s observation that, among other plausible factors, race appears to be the only variable accounting for differentiation among community service packages. This finding is supported by other studies (Logan and Schneider 1984; Miller 1981; Weiher 1991).

The ‘credit claiming–blame avoidance’ practices of elected officials (Donovan 2001) offer a possible explanation for service similarity and revenue differentiation across local jurisdictions. Simple electoral incentives push officials to tout the quality of services and the (relatively) low tax price of their city’s services. Citizens are hard-pressed to judge the validity of service quality claims (so are scholars) and typically possess little knowledge about services in other communities (Lowery, Lyons, De Hoog 1990; Ostrom, Bish, and Ostrom 1988, 90–97). However, citizens are more likely to be sensitive to variations in their tax bill. Consequently, elected officials have incentives to adopt less visible revenue sources—this behavior has been long noted in public finance literature (Ulbrich 2003, 190–91). Furthermore, the relative ease by which citizens can make comparisons among local governments on the price they pay for services compared with the quality they receive sharpens their focus on taxes.

Still, this line of theorizing offers little in the way of prediction as to what might happen to local revenues as a result of devolution. The most direct hypothesis would be that as local service demands increased because of devolution, local officials would seek to engage in one or more strategies: (a) transfer the costs upward, (b) export the costs, (c) seek revenues from superior levels of government, or (d) adopt (or seek permission to adopt) less visible sources of revenues.

The Motivation for Devolution—Slaying the Leviathan

President Reagan’s strategy to devolve public activities from the national to state and local governments was motivated, in a large part, by his ‘long-time dream [of balancing up the divisions of government’ (Nathan and Doolittle 1987, 6; see Conlan 1986, 15), and he tried ‘in a single stroke … [to accomplish] a realignment that will end cumbersome administration and spiraling costs at the Federal level’ (Reagan 1982). In many respects, Reagan viewed the national government as if it were the Leviathan, a ruler or government that systematically seeks to maximize budgetary resources, even over the opposition of the citizens. Devolution was the sword by which he could slay the beast (Krane 1990). His critics may have decried the social consequences of his political strategy, but as an economic policy, it shared a similarity of ideas with a public finance model developed by Brennan and Buchanan (1984).
In seeking a model of fiscal decision making that could inform the constitutional-stage choices of fiscal instruments, Brennan and Buchanan argued that a democratically constrained model of government would be "naive," and therefore, they proposed a model of government "in which the political-bureaucratic process, as predicted to operate post-constitutionally, involves the maximization of revenues within the tax constraints imposed in the fiscal constitution" (1984, 73). Calling their model Leviathan, they assumed that "citizens had no effective control over government, once established, beyond the constraints that are imposed at the constitutional level. [P]ost-constitutional decisions are made entirely by the budget-maximizing or revenue-maximizing politician-bureaucrat" (1984, 73). The only means by which citizens could protect themselves from Leviathan was to write into the constitution institutional devices to limit the revenue-raising potential of rulers. Among the devices Brennan and Buchanan recommended were constitutional limits on tax rates and tax bases, some degree of progressiveness in rate structures, and decentralization. This latter device, they claimed, would take advantage of "interjurisdictional mobility of persons in pursuit of 'fiscal gains'" (quoted in Oates 1994, 147). Thus, devolution was viewed as a strategy to reduce the size of government or, at a minimum, to limit its ability to raise revenue. In an important comment, Brennan and Buchanan warned that "we should, however, recognize that errors can be made in the opposite direction, that the constitutional constraints might, through time, prove to be overly restrictive" (1984, 84). Although they feared the Leviathan, they also exhibited some concern about excessive restrictions on public sector revenues such that necessary goods and services are not provided. Brennan and Buchanan, at this point in their logic, found themselves in a dilemma caught between the desire to restrain revenue-maximizing officials and their fear of a resource-strapped public sector that cannot adequately perform required functions. They attempted to escape this predicament by suggesting that their results "depend critically on the assumed predictions about the properties of the political process [n.b.: they do not define or explain the 'political process')]" (1984, 85). Brennan and Buchanan (1984, 86) suggested that tax comprehensiveness is likely to be rejected under certain political assumptions, and they claimed that their model helps one understand the "attitudes" of taxpayers, who "are likely to react negatively and emphatically to proposals to move toward taxation on the basis of full income" or who "would reject any widening of the tax base" (1984, 85).

Quite simply, the Leviathan model is congruent with the basic Tiebout logic as a mechanism by which to constrain taxes. In addition to the already mentioned studies that offer contradictory evidence to Tiebout's model, research on fiscal decentralization does not support Brennan and Buchanan's hypothesis that smaller government would result from devolution (Heil 1991; Krane 1973; Oates 1985). Consequently, devolution as a strategy to reduce the size of government or to limit its ability to raise revenue was not a policy that could produce the results sought by the Reagan administration.

Unresolved Debates about the Property Tax

Because Peterson claimed the benefit/cost calculus conducted by city officials included a concern for tax incidence, it is necessary to review briefly the studies of property tax incidence. Work on this topic is characterized by two competing conceptions of the property tax—the benefit model and the 'new view.' Each conception has its proponents and opponents, and although the debate between the two sides remains unresolved, the
disagreements do offer some ideas as to how local government officials might respond to devolution.

The ‘benefit view’ of the property tax is the older of the two conceptions, and it is a modified extension of the Tiebout model. Instead of Tiebout’s head tax, the residential property tax is seen to be the key source of revenue for local governments, and strict zoning is added to incorporate homeowners’ pressure on local officials to make land policy decisions that protect the value of their principal asset—their home. Furthermore, because ‘capitalization is everywhere,’ the property tax serves to assign tax liabilities in line with the public service benefits received, and thus it becomes a ‘benefit tax’ (Fishel 2001b, 33–50).

By contrast, the ‘new view’ of property taxes builds from a model of the general national economy and sees housing as one type of capital stock within a larger capital market. As such, housing capital is mobile and can be converted to other uses in the long run. Therefore, local property taxes are, in effect, an excise tax on capital (Zodrow 2001, 80–85). As a tax on capital it discourages building relative to other capital investment and thus distorts local housing markets and local fiscal decisions (Oates 2001, 22). For example, if local governments are restricted by state government to the use of property taxes, then low levels of public services are likely to result.

After nearly thirty years of debate, ‘neither side therefore,’ Nechyba concludes, ‘can demonstrate a history of empirical work that rejects one view in favor of the other’ (2001, 119). Oates is more blunt when he says: ‘I know of no systematic evidence on this matter [the choice between the two views on the property tax]’ (1994, 146). Nechyba puts the responsibility for ambivalent results on the nature of the data when he says that ‘the main piece of empirical evidence in favor of the benefit view is anecdotal’ (2001, 119). As for the behavior of local officials, the research on the property tax has produced a similar result: there is no clear evidence from either of these models as to whether local governments will under- or overproduce local public services. However, what we might expect to find is that if the ‘benefit’ model is operative, then local governments will rely heavily on the property tax, despite the incentives not to do so as hypothesized by the ‘new view.’

Fiscal Federalism—A Brief Summary

This review of theories of fiscal federalism does not produce clear directions about the course of local revenues within the current dynamics of state–local relations. One is left with the unfortunate conclusion that theories of fiscal federalism have not done a very good job in predicting and explaining the actions of local governments. The problem appears to be, in part, the normative nature of the Musgrave, Tiebout, and Brennan and Buchanan theories. Another part of the problem stems from what has been left out. Stein tells us that in the competitive model of federalism, ‘politics, at least at the subnational level, is marginalized…. Politics in the form of public preference is not important to the formation of most municipal public policies, at least not those associated with significant redistributive effects’ (1999, 27).

It seems apparent that the response of local governments to devolution will be shaped by the macro trends affecting state–local relations and by the institutional attributes of local government. Ladd and Yinger, in their extensive study of municipal fiscal health, conclude that cities have a limited ability to help themselves because ‘economic, social, and institutional factors that are largely outside the city’s control’ affect a city’s fiscal health
They further claim that ‘poor management, corruption, or profligate spending’ are not causes of this limited municipal fiscal ability (1989, 291). Ladd and Yinger suggest that city officials, although their fiscal tools are limited, should continue to strive to make decisions that maintain or improve public services, but this is only possible if state government permits the use of a policy tool such as a local option sales tax. Their prescription rests on the rules and structures that create the institutions of local government.

An alternative theory of fiscal federalism should call attention to the crucial fact that ‘institutions matter’ (March and Olsen, 1984). It is increasingly evident that models that omit institutional features are incomplete: ‘Local governments then are bundles of particular institutions—for example, the power to zone, the power to tax, and the power to provide services’ (Burns 1994, 8). After all, the ‘creatures of the state’ theory of state–local relations rests on the legal authority of state government to determine the institutional features of local government (Krane, Rigos, and Hill 2001). The response of local governments to trends in their larger environment will be shaped by their institutional features. These institutional features determine what options are feasible for local governments. In a pragmatic search for the option that best addresses the challenges they face, local government officials will continue to negotiate with state government and try to alter the institutional arrangements of state–local relations. This path of development is best understood in a historical light for each of the fifty state systems (North 1990). Broad normative theories that abstract from the structure of laws and institutional powers relevant in each case are not likely to help us describe or predict developments in local revenues or other features of intergovernmental relations. Instead of theories of what local governments should do, what is ‘badly need[ed]’ and what is called for by many theorists is empirical evidence about what they have done (Oates 1994, 133). It is to an empirical profile of recent and significant municipal government revenue trends that this essay now turns.

THE SHIFT IN MUNICIPAL GOVERNMENT REVENUES

Unfortunately, normative theories of fiscal federalism are often presumed to possess explanatory power; but, as noted in the previous section, evidence in support of particular prescriptions is often thin at best. In a recent discussion of subnational taxation, Bird observes: ‘The tax assignment that actually prevails in any country inevitably reflects more the outcome of political bargaining in a particular historical situation than the consistent application of normative principles’ (1999, 9). Because political bargaining over revenues is so contentious, existing bargains are not easily altered. McLure (2001, 359) labels this situation the ‘tyranny of the status quo’ and pointedly observes that the U.S. state–local fiscal structure exhibits this ‘tyranny.’ Evidence of a tyrannical ‘status quo’ would be found in the lack of temporal change in the reliance on a given revenue source.

In this section we describe recent trends in the sources of municipal revenues and examine the extent to which changes in municipal revenue sources conform to prescriptions for tax assignment drawn from theories of fiscal federalism. Though a few scholars have also explored some of this same ground (e.g., Fisher 1996; Stephens and Wikstrom 2000), it is striking the extent to which numerous scholars continue to describe state–local fiscal relations in a status quo fashion. For example, Miller claims that ‘comparing and contrasting sources of local government revenues between 1982 and 1996 reveals a fairly stable picture’ (2002, 12). Tannenwald states that ‘local own-source revenues are even less diversified than those of the states.’ However, since the property
tax remains the backbone of local revenue systems, forces eroding its long-term productivity continue to worry local policymakers’ (2002, 471).

Declining Importance of the Municipal Property Tax

Duncombe and Yinger assert that ‘the property tax, long the mainstay of the local tax system, is a highly visible, and hence unpopular tax, at least for homeowners’ (2001, 243). Though the property tax continues to be highly visible and a flash point of state and local politics, its status as the ‘mainstay’ of local government revenues is no longer assured. Through the twentieth century, taxes as a proportion of local government revenues declined gradually from 82.4 percent in 1902 to 37.6 percent in 1999. The property tax as proportion of total general revenues (including intergovernmental transfers) has dropped more rapidly from about 73 percent in 1902 to about 27 percent in 1997 (American Council on Intergovernmental Relations 1998; Bureau of the Census 2000).

The reduced status of property taxes can be seen more clearly in the declining proportion of own-source municipal revenues. Property taxes constituted 42.7 percent of municipal own-source revenues in 1977 but only 28.8 percent in 1997—a proportional drop of nearly one-third. During this period only in Alabama did property taxes as a percent of own-source revenues increase (1.41 percent). In the other forty-nine states this percentage declined, ranging from a 1.19 percent reduction in New Hampshire to 44.4 percent in Idaho (Bureau of the Census 1977, 2000).

Intriguingly, but not unexpectedly, the reasons for the movement away from the property tax remain a matter of some debate among public finance scholars. The most commonly accepted thesis holds that the tax and expenditure limitations (TELs) movement beginning in the 1970s transformed the vertical fiscal structure of state–local relations (Joyce and Mullins 1991; Shedbegian 1999). By imposing structural constraints on local government fiscal decisions, TELs reduced local discretion and autonomy and increased centralization of state and local finances (Saxton, Hoene, and Erie 2002). In her study of tax revolts, McCabe estimated that the imposition of assessment limits and tax rate limits on ‘cities’ reliance on the property tax dropped by an average of 5.6 percent, while holding other variables constant’ (2000, 216). Some scholars go so far as to argue that ‘we can no longer characterize the property tax as a locally determined revenue source in many states; rather, it resembles more a fiscal tool of the state government’ (Sokolow 2000, 86).

Other researchers point to a substantial growth in state government aid to local units as the obvious factor in the declining proportion of local revenues represented by property taxes. Fisher offers this evidence:

Between 1965 and 1991, total state payments to local governments rose by 1,216 percent. Payments for educational purposes rose by a slightly higher 1,290 percent. In comparison, local government own-source revenue rose by 950 percent and property tax revenue by 641 percent. Clearly, property tax revenue is growing less rapidly than the total own-source revenues of local government, but state payments to local governments are growing much faster than local government own-source revenue. (1996, 203)

Fisher (1996, 208) bolsters his case by reminding others that property tax revolts are not new and occur periodically and that since 1978 numerous proposed TELs have been defeated at the polls.
A third suggested cause of the movement away from the property tax is judicially driven school finance reform initiated by the California state supreme court decision in Serrano v. Priest (96 Cal.Rptr. 601 [1971]). Fishel states: "The spread of Serrano-like court cases around the country has, I submit, contributed to a dissatisfaction with local property taxation" (2001a, 98–99). Fishel also points out that the Serrano decision, as it spread across the country, resulted in "almost completely centralized school financing and soon thereafter local property taxes were capped by legislative action in response to local dissatisfaction with them" (2001b, 64–65).1

Current research continues to yield evidence in support of each thesis and bolster our point about the importance of historical development and institutional structure in any explanation of local revenue trends. By 1997, thirty-seven states had some form of restriction on local property taxes (Mackey 1997), and the existing literature demonstrates that reductions in property tax reliance occurred after a TEL was imposed. Sokolow (2000, 87), while lamenting the negative effects of TELs on local governments, observed that much of the reduction in property tax reliance can be attributed to enlarged forms of federal and state aid. Since Serrano, constitutional challenges to school financing systems have been brought in forty-three states, and by the early 1990s twenty-nine states had court-ordered school finance reforms (Evans, Murray, and Schwab 2001). Even in the absence of definitive comparative research, one can conclude with some assurance that all three of these factors have contributed to the movement away from the property tax. However, a newer line of research suggests that a fourth factor contributes to the movement away from the property tax, and it is to that determinant we now turn.

Alternative Sources of Municipal Revenues

With increased restrictions on the property tax and declining intergovernmental aid to local governments (as documented earlier), municipalities sought other sources of revenues. Although much of the commentary as well as the research has focused on the limitations imposed on local government finances, state governments in recent years have also granted local governments a considerable amount of fiscal discretion. States have significantly increased the variety of revenue sources municipal governments may tap, and local officials have made more expansive use of traditional but underutilized sources. A list would include not only sales taxes (general or selective), income taxes, and entertainment and tourism taxes but also business, occupation, and professional fees; current charges (user fees); franchise fees; gaming fees; licenses; and permits, as well as interest income, municipal enterprises, rents and royalties, and utility funds (Krane 1999).

To illustrate, the number of states authorizing local use of sales taxes steadily increased from one in 1950 to twelve in 1963, twenty-five in 1970, thirty-one in 1994, and thirty-three in 1997 (Mackey 1997). Sales and gross receipts as a proportion of municipal own-source revenues averaged 17.1 percent in 1997, but the range varied considerably from no local sales taxes permitted in New Hampshire to Colorado, Oklahoma, and Alabama, where sales taxes accounted for about 40 percent of municipal own-source revenues. In twelve states, sales tax exceeds the property tax as a percentage of own-source revenues. Bartle notes that

1 Fishel is correct when he says there has been a significant shift toward state funding of public education. In 1959 state funding for education accounted for 38.3 percent of state and local spending on education; in 2002–2003, the state percentage was 53.8 (National Education Association 2003; Wong 1999). However, it is fair to say that Fishel overstates the degree of centralization.
generals sales taxes are used by cities in more than half of the states, and are over 15 percent of total revenue in Alabama, Arizona, Colorado, Louisiana, Missouri, Nebraska, New Mexico, Oregon, South Dakota, Texas, and Utah” (2003, 27). The trend toward the sales tax as a key component of municipal purses is most evident in larger cities: “Of the largest thirty-eight cities, six (Albuquerque, Denver, Nashville, Oklahoma City, Phoenix, and Tucson) derive more than 20 percent of their revenue from this tax” (Bartle 2003, 27).

Nonproperty taxes were not listed separately in the 1977 Census of Governments, but in 1997 these taxes accounted for 30.4 percent of municipal own-source revenues. This category includes excise taxes on a diverse set of products and services. It is important to note that nonproperty taxes constitute, on average, a larger portion of municipal own-source revenue than do property taxes (in 1997: 30.3–28.9%). Likewise, current charges as a proportion of municipal own-source revenues increased from 18.6 percent in 1977 to 26.6 percent in 1997—nearly equal to the percent accounted for by property taxes. Miscellaneous revenues grew from 10.2 percent in 1977 to 14.1 percent in 1997. A simple comparison of the combination of current charges and miscellaneous revenues (31.2 percent) to property taxes (28.8 percent) demonstrates the reduced status of municipal property taxes by 1997. Current municipal charges during this period increased on average by 8 percent, whereas property taxes decreased on average by nearly 14 percent: or a 32 percent decline in property taxes as a proportion of own-source revenues versus a 43 percent increase in current charges. These changes are neither gradual nor insignificant (Bureau of the Census 1977, 2000).

Although Philadelphia levied the first local income tax in 1938 (Rogers and Temple 1996), the enactment of state statutes permitting local governments to collect a tax on individual or corporate income is a relatively recent trend. More than a dozen states now authorize a local income tax, and although the proportional size of this revenue stream is not yet large (approximately 2.5 percent of total general revenue), for many of the country’s most populous cities, income and earnings taxes account for about half of the city’s revenues. Examples include Cleveland, Columbus, Cincinnati, Detroit, Kansas City, Philadelphia, St. Louis, and Toledo (Bartle, Ebdon, and Krane 2003).

Where not too long ago the property tax was the “mainstay” of municipal revenues, its current status is substantially reduced. In a dozen states charges and user fees are the “main” source of city revenues, in six states the primary source is the local sales tax, state aid is the largest source in four states, and in one state business and commercial fees make up the bulk of city revenues (Krane, Rigos, and Hill 2001). Municipalities in almost half of the states garner more revenues from sources other than the property tax. This movement away from the property tax invalidates the view still held by many fiscal analysts cited above. Simply put, this is a sea change in municipal finances, and these trends discredit the so-called tyranny of the status quo in tax assignment. Although the causes of these changes are far too numerous to discuss here, our previous work suggests that these changes are the result of a variety of pragmatic decisions by local officials and their negotiations with state government authorities (Ebdon, Krane, and Bartle 2001).

FISCAL THEORY AND DEVOLUTIONARY REALITY

As a policy strategy, devolution is the logical opposite of market theories of fiscal federalism. The ideas put forward by Musgrave and Tiebout prescribe a distinct functional
division of labor among tiers of government and a set of recommendations for the appropriate assignment of revenue sources among governments. Musgrave's recommendations dictate that (1) highly progressive taxes should be centralized, (2) a revenue source with a highly unequal distribution of its base ought to be used by the central government, (3) taxes on mobile tax bases should not be used by lower-tier governments, and (4) user taxes are especially appropriate for the lowest tiers of government. Competitive fiscal federalism derived from Tiebout's market model holds that local governments cannot sustain redistributive programs and, therefore, that these programs should be assigned to higher tiers of government, with corresponding revenue sources as well. Peterson, one of the chief architects of competitive federalism, counsels that local governments should not adopt sales or income taxes; rather, they should continue to rely on the property tax and to limit user fees to the cost of services. Brennan and Buchanan's Leviathan model recommends decentralization to control revenue growth, but these authors also fear that this recommendation could just as easily result in overly restrictive public service provision. Research on the incidence of the property tax, after a quarter century, remains trapped in ambivalent conclusions about the effects of the tax.

The profile of municipal government revenue trends presented here belies the advice offered by theories of fiscal federalism. That municipalities rely on a mix of revenue sources—current charges, business and occupational taxes, entertainment and tourism taxes, property taxes, sales taxes—runs counter to Musgrave's recommendations. Of his four recommendations, only his prescription that user fees are especially appropriate for lower levels of government is confirmed by the trends in municipal revenue sources. Even Musgrave's recommendation to centralize highly progressive taxes such as an income tax is being ignored, as evidenced by the emerging use of local income taxes. Likewise, municipal revenue trends run counter to Peterson's prescriptions, in particular his opposition to local sales taxes. Where once there was a reasonably exclusive assignment of a revenue source to a given level of government, trends over the past quarter century have done away with this neat distinction. As a consequence, existing theories of fiscal federalism provide little if any explanation for these changes in local revenue sources. Nor does this body of theory offer any advice to local officials on how to respond to "second-order" devolution. Imagine the fiscal stress of municipalities had the recommended assignment of revenue sources been followed to the letter.

Many of the efforts to understand recent trends in municipal revenues have concentrated on three factors: TELs, state aid, and judicial decisions on school finances. Although these factors contribute to our understanding of this shift, the movement away from the property tax predates two of these three factors. As McCabe's research demonstrates, "declining property tax reliance was underway before the tax revolt's official kick-off in 1978, and the pre-tax revolt period showed a greater rate of decline in property tax reliance than did the post tax revolt period" (2000, 220). Only the initial judicial rulings on school financing were coterminous with the pre-tax revolt period, but these court cases were not the sole cause of movement away from the property tax. The obvious, but often overlooked, factor of citizen demand for services affected reliance on the property tax. Population growth in the form of urbanization coupled with rising incomes and the development of a service-based economy meant that local governments could capture more elastic revenue sources (McCabe 2000, 219). Tannenwald explains that "the property tax in the United States has increasingly become a tax on realty (Youngman 1998)" (2002, 476), as municipalities have backed away from its application to the
tangible personal property of businesses (Brunori 2001). The combination of growing demand for municipal services and the decisions of municipal and state officials to reduce taxes on tangible property, along with the opportunity presented by growing sales and income tax bases, offered localities in many states the options to seek out new revenue sources and exploit underused ones.

More recently, as the costs of Medicaid and corrections consumed more state government funds, states reduced aid to localities, and this led states to ‘leave much of the tax increasing to local governments’ (Gold and Wallin 1999, 73). One would have expected an increasing reliance on property taxes, but the tax and expenditure limitation crusade closed off that option, thus the shift away from property taxes and toward alternative sources of revenue by municipalities. Again, this pragmatic response is consistent with our emphasis on the historical development of institutional arrangements.

At approximately the same time of the Serrano-type decisions on school finances, state governments experienced a prolonged and profound period of institutional change, the details of which have been well described elsewhere (Bowman and Kearney 1986; Walker 1995). One little-noticed institutional change was the increase in local government discretionary authority created by state governments. This increase in local government discretion was not confined to legal or structural matters, often associated narrowly with the concept of home rule. States granted municipalities expanded authority in functional responsibilities, administrative procedures and systems, planning and economic development, and expenditures and revenues (Cigler 1997; Krane, Rigos, and Hill 2001).

‘Although state governments hold legal supremacy in fiscal affairs,’ Krane explains that ‘the reality of actual practice is more complex and varied’ (1999, 277). Stonecash, in a comparative analysis of state–local fiscal relations, finds that ‘there is considerable variation in the role of state government in state–local fiscal responsibilities, and in the degree of interdependency between the two levels’ (1998, 89). This fits with the emphasis on the negotiated relationship between local and state governments. The wide interstate variation in each of the principal revenue sources of municipal governments, noted in the previous section, is evidence consistent with this view. A good example is the growth in the use of the local option sales tax; here local residents or the city council have voted to adopt this new revenue source. Another example of local fiscal discretion can be found in the enlarged array of financial instruments authorized for use by municipal governments, including tax increment financing and other forms of abatement or exemption from property taxes for purposes such as ‘brown field areas,’ enterprise zones, and free ports (Krane 1999).

What is noteworthy about this movement away from the property tax and toward alternative revenue sources is the increase in fiscal discretion state governments have granted and continue to grant to municipal officials. Much of the original impetus may well have been a reaction by state legislators to the public’s view that the property tax is the ‘worst tax’ (Fisher 1996). But today another driver of the growing municipal reliance on nonproperty tax sources is the increasingly accepted view that revenue diversification is equated with good financial management. The National Advisory Council on State and Local Budgeting and the Government Finance Officers Association encourage a balance of revenue sources (Dennis and Statler 2002, 2). Studies of diversification are just beginning, and early results have found that revenue diversity does lead to higher tax effort, but it also moderates instability (Pagano and Johnston 2000, 169–70; also see Suyderhoud 1994). Revenue diversification and consequent fiscal balance may not possess the theoretical
cachet accorded to the models of fiscal federalism reviewed here, but its growing reality speaks volumes about its practical value in support of an institutionalist-based explanation of local government (Frederickson and Smith 2003).

A CONCLUDING NOTE

The disjuncture between the prevailing normative theories of fiscal federalism and the changes in municipal revenue sources we have described should not lead researchers to reject economic analyses of state–local relationships. Rather, the apparent mismatch between the theory and the reality of municipal revenues suggests that we should follow Douglass North’s advice to incorporate institutional features into our analyses because, as he noted, ‘the traditional public choice literature is clearly not the whole story’ (1990, 140). To emphasize institutional aspects of intergovernmental relations and local governments is, of course, not new. After all, there is a long history of research into the consequences of municipal reforms. More recent scholarship on local governance also highlights the importance of institutional analyses (for example, see Boschken 2002; Clingermayer and Feiock 2001). What is required is the recognition that the theories of state–local relations and of local government behavior reviewed here are founded on normative premises and have not explained recent developments in local fiscal policy. This is in part because they ignore the lesson of institutionalism—Institutions create incentives that in turn shape future institutional developments. Institutional structures matter because they may facilitate or hinder the behavior of actors operating within the institutional structure, and conversely, actors may alter institutional structures.

Robert Stein suggests that ‘there is increasing evidence that market explanations of subnational politics and policy rely on institutional factors’; this is so, he argues, because ‘rules and structures matter’ and ‘the states, not the federal government, hold the key to successful devolution of federal responsibilities to local government’ (1999, 36–37). But which are the rules and structures that ‘matter’ in regard to devolution? Our view is that the successful devolution of programmatic responsibility to local governments by state and national governments will turn on the capacity of local governments to implement and support the devolved activities (Burgess 1975; Gargan 1997). ‘The capacity to take on responsibilities,’ Kodras notes, ‘is defined by the extent to which fiscal resources, expertise, infrastructure, and political will exist, or can be cultivated within particular localities’ (2001, 185). Kodras continues by observing that devolution ‘opens new regulatory spaces [i.e., opportunities] for local initiatives’ (2001, 186). Local governments and their officials are not helpless in the face of larger economic and political trends. They ‘can alter their governing capacity from conditions of insufficiency to sufficiency by several means’ (Gargan 1997, 518), among which are the rules and structures of state–local revenue systems. Revenue diversification offers an important example of change in the governing capacity of state and local governments.

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