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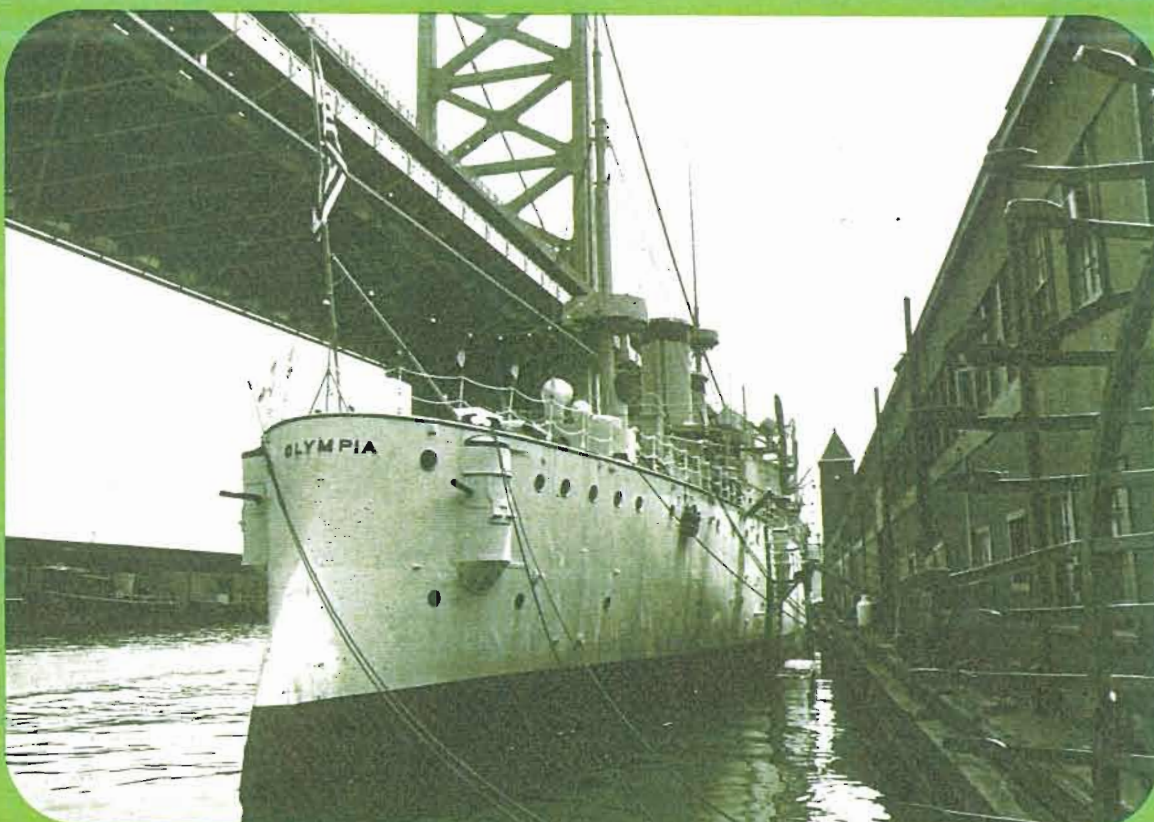

1975

IN THIS ISSUE . . .

On our cover: In Philadelphia at Pier 11 on the Delaware River is the *U. S. S. Olympia*, one of the few reminders left of the Spanish-American War. Flagship of Commodore (later Admiral) George Dewey at the Battle of Manila Bay in May 1898, she is the oldest steel Navy vessel in existence. A museum aboard contains pictures of the *Olympia*, uniforms of officers and enlisted men, and memorabilia of the ship.

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Anatomy of a "Fiscal Crisis"

By Anthony M. Rufolo

Although the fiscal plight of New York City has been making headlines, most local governments now complain that expenditures are growing faster than taxes. Many residents demand increased services despite rising costs, but they quickly rebel at attempts to raise more tax dollars. Nearly everyone wants more goods and services for less money, so these demands don't seem unusual. It's one way for citizens to remind City Hall that every expenditure decision involves a budget tradeoff. After all, as economists never tire of pointing out, resources are limited and budgets limit their use. However, mayors in certain areas—particularly central cities—fear that if they fail to maintain the same level of services or to clamp a lid on taxes, the exodus of jobs and wealth to the suburbs may accelerate. Many of them call this a "fiscal crisis," conjuring up visions of nothing but abandoned buildings and jobless poor. Is such alarm justified, or are some city administrators simply rebelling against the constraints of their budgets?

Taxpayer Smith may forsake the paved sidewalks of the city for the manicured lawns of suburbia for any number of reasons. He may commute a greater distance for more open living space. He may want his children to attend a suburban school. If he moves from one suburb to another, generally no one would care. But a move from city to suburb makes him another statistic to furrow the city mayor's brow. The likeliest candidate for such a move is the relatively wealthy taxpayer.[1] For example, Smith's contributions to the city's coffers may be more

[1]One author found that "between 1959 and 1969, the median income of central city families dropped from 89 percent of that of suburban families to 83 percent." See Joseph A. Pechman, "Fiscal Federalism for the 1970's," *National Tax Journal* 24 (1971): 285.

than it actually costs to provide him with government services, so he pays for services for relatively poor taxpayer Jones as well. This redistribution of income provides an incentive for Smith and others like him to leave the city, thereby putting increasing pressure on city budgets. Thus, income redistribution at the local level may be a major force behind the "fiscal crisis."

So far, no major cities have folded. Perhaps the danger signals were heeded before the situation became hopeless. Recently Federal revenue-sharing funds have helped relieve the pressure on city budgets. But the underlying source of the problem may still be with us. An analysis of what makes a fiscal crisis is in order, so that the pros and cons of proposed solutions can be weighed intelligently. Perhaps there is a solution which attacks the source of the problem rather than its symptoms.

CITY VERSUS SUBURBS

Every government has budget constraints, so why must *only* major cities face crises? One reason for the difference in ability to cope is that suburban communities have been more successful in attracting the "Smiths" and banning the "Joneses."[2] This creates a problem for the city because the poor require relatively more services from government but have less ability to pay. More low-income residents force a larger tax burden on city businesses and wealthier residents or shift services away from them, or both. Some of these businesses and individuals avoid this increased burden by just moving to the suburbs. This movement in turn leads to greater tax burdens and/or decreased services for those remaining in the city. The poor don't emigrate because of inadequate low-cost housing or poor public transportation in the suburbs as well as barriers such as zoning restrictions.[3] This population shift then affects government budgets, and a quick review will show that cities' tax bases relative to expenditures are not keeping pace with the suburbs'.

The property tax is the primary source of most locally raised revenue. In the early '70s, property taxes accounted for 82 percent of all tax revenue of local governments in metropolitan areas and 40 percent of their total revenue from all sources.[4] However, this important component of the tax system has its base rising more slowly in central cities than in the suburbs. For example, real estate values in Philadelphia increased by 29 percent from 1962 to 1972 while those in the surrounding counties of Delaware, Montgomery, and Bucks posted increases of 38, 77, and 100 percent respectively (see Table 1).

At the same time population has been growing fairly fast in the suburbs while it has actually declined in Philadelphia (Table 2). The result is that tax base per person has grown at a similar rate for each county (Table 3). However, expenditure per person is rising fastest for Philadelphia (Table 4) so that even adjusting for population, total expenditures are growing faster in Philadelphia (Table 5). Thus, while expenditures are rising faster than the value of the property base in all four counties, the difference is largest for Philadelphia.

Several major cities have turned to a wage or income tax to pay for services without increasing the tax burden on real estate. In Philadelphia, for example, between 1962 and 1972 property tax revenues increased by less than 45 percent while total tax revenue almost doubled. In large part the wage tax took up the slack. Unfortunately, however, shift-

[2]There are exceptions, of course, and those suburbs which have not been successful at this face the same type of problems as the central cities.

[3]A recent New Jersey Supreme Court ruling has as its intent the removal of these barriers with respect to housing, but its impact cannot yet be determined. See "Zoning and the Citizen" in the *New York Times*, April 1, 1975.

[4]U.S. Department of Commerce, Bureau of the Census, *1972 Census of Governments, Local Government in Metropolitan Areas,* p. 8.

TABLE 1

THE TAX BASE* (MARKET VALUE OF REAL ESTATE) IS RISING FASTER IN THE SUBURBS**

	Philadelphia County	Bucks County	Delaware County	Montgomery County
1962	$5889.8	$1237.9	$2142.8	$2664.5
1972	7617.0	2474.8	2961.2	4708.5
Change (1962–72)	$1727.2	$1236.9	$ 818.4	$2044.0
Percent Change (1962–72)	29.3%	99.9%	38.2%	76.7%

*Dollar figures are in millions.

**Chester County is not included because it is not contiguous to Philadelphia County.

SOURCE: Pennsylvania Department of Commerce, *Pennsylvania Statistical Abstract*.

TABLE 2

BUT SO IS THE POPULATION

	Philadelphia County	Bucks County	Delaware County	Montgomery County
1962	2,002,512	308,567	553,154	516,682
1972	1,950,098	415,056	601,425	623,921
Percent Change	−2.6%	34.5%	8.7%	20.8%

SOURCE: U.S. Department of Commerce, *Census of Governments—Compendium of Government Finance*, Table 53.

TABLE 3

LEAVING TAX BASE PER PERSON GROWING AT SIMILAR RATES

	Philadelphia County	Bucks County	Delaware County	Montgomery County
1962	$2941.2	$4011.8	$3873.8	$5156.9
1972	3906.0	5962.6	4923.6	7546.6
Percent Change (1962–72)	32.8%	48.6%	27.1%	46.3%

SOURCE: Tables 1 and 2.

TABLE 4
EXPENDITURE PER PERSON IS RISING SIGNIFICANTLY FASTER IN PHILADELPHIA THAN IN SURROUNDING COUNTIES*

	Philadelphia County			Montgomery County			Delaware County			Bucks County		
	1962	1972	Percent Change	1962	1972	Percent Change	1962	1972	Percent Change	1962	1972	Percent Change
Expenditure per Person	$209	$635	203.8%	$183	$436	138.2%	$155	$326	110.3%	$213	$463	117.4%
Revenue per Person	$209	$590	182.3%	$169	$432	155.6%	$145	$338	133.1%	$185	$455	145.9%
Intergovernmental	34	216	535.3	29	92	217.2	26	96	269.2	44	150	240.9
Own Sources	175	374	113.7	140	340	142.9	119	242	103.4	154	305	98.1
Intergovernmental as Percent of Total	16%	37%	131%**	17%	21%	24%**	18%	28%	56%**	24%	33%	37%**

*Dollar figures are in millions.

**Represents rate of growth of intergovernmental as percentage of total revenue.

SOURCE: Same as Table 2.

TABLE 5
WHILE TOTAL EXPENDITURES ARE RISING ONLY SLIGHTLY FASTER

	Philadelphia County			Montgomery County			Delaware County			Bucks County		
	1962	1972	Percent Change	1962	1972	Percent Change	1962	1972	Percent Change	1962	1972	Percent Change
General Revenue	$418.6	$1151.6	175.1%	$87.4	$269.5	288.4%	$80.0	$203.8	154.8%	$57.0	$188.5	230.7%
Intergovernmental	67.8	421.9	522.3	14.8	57.2	286.5	14.2	58.0	308.5	13.6	62.2	360.3
Own Sources	350.9	729.7	108.1	72.5	212.3	192.8	65.8	145.8	121.6	47.4	126.4	166.7
Taxes	279.4	557.0	99.4	58.5	168.1	185.9	53.2	118.7	123.1	32.1	96.2	199.6
Property	162.9	231.3	42.0	53.2	152.6	186.8	49.4	111.4	125.5	27.6	84.8	207.2
Other	116.5	325.7	179.6	5.5	15.5	181.8	3.8	7.4	94.7	4.5	11.4	153.3
Direct General Expenditures	$417.6	$1237.9	196.4%	$94.7	$272.2	186.4%	$85.7	$196.1	128.8%	$65.6	$192.2	193.0%

*Dollar figures are in millions.

SOURCE: Same as Table 2.

ing to a different tax is not likely to alleviate the problem (see Box 1). City residents paying more in total local taxes than it costs to serve them are still likely to have an incentive to move to the suburbs. It is this incentive that is at least partially behind the fiscal plight of many major cities.

LOCAL INCOME REDISTRIBUTION: AN INCENTIVE TO MOVE?

Most people consider political factors as the primary determinants of the tax rates and services provided by a local community. Residents as voters register their desires through elections, and the elected representatives try to coordinate the often conflicting goals of various groups. Some economists, however, emphasize a rather different aspect of this process. They point out that communities can be considered as sellers of a package of goods and services who charge a certain tax-price for the package. So while a resident/voter can try to influence what local government does, he can also decide to move to a community more tailored to his

BOX 1

HIGHER RESOURCE COSTS VERSUS INCOME REDISTRIBUTION

There are, of course, many reasons why a central city might have faster growing expenditures per capita than do the suburbs. However, most of these phenomena do not create distortions in the economy. When the higher expenditures and, hence, higher taxes represent the cost of serving residents, then the movement of residents to find more services for fewer tax dollars is beneficial to the economy. For example, if wages and land costs are rising fast in the city and this raises the cost of running local government, then someone who moves out frees the resources which were used to provide him with services. This person is made better off and no one is worse off. However, if taxes are high in order to pay for the services which someone else receives, then moving out lowers the city's income by more than it lowers expenses. In this situation, even people who would be willing to pay the cost of service to them may be driven away. This then raises the tax burden and/or lowers service levels for those remaining and may lead to the cumulative process discussed in the text.

The same situation arises no matter who is being subsidized. For example, some people argue that suburbanites directly exploit the central city. They commute in and impose costs on the local government and then leave without paying any taxes. Partially in response to this argument, some central cities levy wage or income taxes; however, there is very little evidence to support this allegation.* To the extent that this does happen, a wage tax can offset the income redistribution to suburbanites; but if it does not happen, the wage tax will distort location decisions in favor of suburban jobs. The discussion in the text is equally applicable to all types of local income redistribution.

*For a detailed discussion, see "Suburban Exploitation of Central Cities," by David F. Bradford and Wallace E. Oates, presented at the Urban Institute conference on "Economic Policy and the Distribution of Benefits," held in Washington, D. C., March 23–24, 1972.

preferences. Consumers in a sense "shop" among communities much as they shop among stores for goods.

Unfortunately, though, this analogy has its limitations. There are easily recognizable differences between the way stores sell and the way local governments "sell." Stores charge directly for the items bought while governments charge indirectly by taxing sources such as property or income. This difference affects people when they are "community shopping."

The major effect is that people do not necessarily contribute equally to the cost of public goods and services, even if they receive the same benefits. For example, with a property tax, a person with a small house might pay much less in taxes than a neighbor with a big house although both may send the same number of children to the same school. This local redistribution of income may be desirable on equity grounds (if we accept "ability to pay" as our equity criterion), since presumably the resident of the larger house is wealthier. (See Box 2.) However, such a situation motivates the person paying higher

BOX 2

EQUITY, PRODUCTION EFFICIENCY, AND SOCIAL EFFICIENCY

There are two criteria which appear to be used most in judging governmental actions—equity and efficiency. Equity relates to "equal treatment." Unfortunately, this is about all that can be said in this area without provoking some controversy. Does it relate to equal treatment of equals or equal treatment of everyone? Should the poor get the same as the rich, or more, or less?* Government is often in the position to provide different levels of services to different groups or to charge them different taxes. When government actions in this regard favor the poor, there is essentially a transfer of income. This transfer of income is carried out for equity purposes. Thus, one goal of government could be to promote equity through income redistribution.

Efficiency can be broken down into production versus social efficiency. We can look at production efficiency as being the least costly production of a given good or service and social efficiency as being the production of goods and services most desired by consumers. For example, a firm may be a very efficient producer of buggy whips in terms of keeping the cost per whip down, but it may be wasting resources because no one wants buggy whips. This would be a case of production efficiency which is not social efficiency. In a competitive economy, such a firm would go out of business; however, government subsidies might allow it to remain in operation. Similarly, other firms in some noncompetitive positions may be producing desirable goods but in a very costly manner. As long as the goods are worth more than the resources used in producing them and they would not otherwise be produced, then it may be socially efficient to provide them although we don't have productive efficiency. Thus, productive efficiency and social efficiency are two other possible goals of government.

*For a treatment of some of the issues, see Anita A. Summers, "Equity in School Financing: The Courts Move In," *Business Review* of the Federal Reserve Bank of Philadelphia, March 1973, pp. 3–13.

taxes to try isolating himself from the person paying lower taxes, since the wealthier resident is, in a sense, paying part of the poorer person's bill. Each person has an incentive to live in a community in which he has less property (and hence lower tax payments) than anyone else in the community. Of course, everyone cannot have less than the average amount. The only stable solution to this type of system would seem to be one in which each resident of a community has approximately the same amount of property and makes similar tax payments.[5] All persons who want smaller houses or apartments would be kept out by zoning laws or similar arrangements.

[5]Renters are assumed to pay property taxes through their rent payments.

Redistribution and Efficiency. Economics tells us that if the price of something corresponds to the costs of providing it, then our scarce resources will be channeled to their most highly valued uses. When local governments charge tax "prices" unrelated to the costs of the services they provide, these resources may end up in inefficient uses. For example, consider our friend Smith's decision to move from the city to the suburbs. Suppose he was entirely happy with the services he received but discovered the same services could be received in suburbia for lower taxes. If the cost were the same in the two places, but taxes were higher because of local income redistribution, then Smith's move would waste both the resources involved in the actual move and those used in his daily commuting. However, if taxes were different because the suburban government had lower costs, then Smith's move would result in the saving of resources employed in providing the services. This saving would be balanced against the cost of Smith's moving and commuting. In this case moving would mean not only a cost saving to him, but more efficient use of society's resources would result (Box 2).

If suburban communities succeed in keeping out low-income residents, they reduce the incentive for *current suburbanites* to move around. This can cut the loss of resources resulting from a game of "musical chairs" among communities. However, this cannot reduce the loss of resources because of excess movements out of the city, and it reinforces the result of little or no income redistribution at the local level.

This description of how people choose a community may seem an extreme case, and it certainly omits other important factors which shape a location decision. However, tax-benefit considerations may have significantly influenced the movement to suburbia and may have helped create communities where all the residents have very similar characteristics. To the extent that this process really operates, it can thwart the attempt of cities to pay for the services they provide by redistributing income through taxes. In fact, attempts to redistribute income locally through taxes can not only influence the movement of people and jobs out of the city, but can also backfire and deepen the plight of the poor.

Redistribution and Low-Income Residents. If attempts to redistribute income lead to separation of families by income class, then the poor could be worse off than if no income redistribution were attempted. This is because current financing only allows communities with a large tax base per person to provide large amounts of goods and services per person. Thus, it is usually necessary for each resident of such a community to buy a large house or rent an expensive apartment. A poor family desiring high levels of some public services (education, for example) would then have to pay for large amounts of housing as well as for the services they desire. While low-income families might be able to afford payments for the services, they obviously cannot also afford large payments for housing. Efforts to encourage low-income housing in the suburbs have encountered stiff opposition, with income redistribution probably a major objection. The likely outcome is that the poor with their demand for services are "locked" into the central city. And, there's the heart of a "fiscal crisis."

So, cities face the problem of providing goods and services which are increasingly more costly to a population which has a growing percentage of those with the least ability to pay. This leads to high-tax and low-service levels for those who can pay. To avoid income redistribution payments at the local level, some people who would otherwise have stayed in the city may incur the costs of moving and commuting. They might also move to a community which provides a different amount of public services than they would choose if they were bearing the direct cost.

The net result is likely to be some waste of society's resources, very little actual income redistribution at the local level, and forces continuing to militate against locating in the central city. While there are many factors creating fiscal pressure on the city, this one may truly be called a "fiscal crisis," for the situation cannot be controlled from within the city. However, this does not imply that all cries of "crisis" should be treated the same. If the city is driving away jobs and residents because it has high production costs or is inefficient, the situation should be labeled an internal management problem, not a crisis.

PROPOSED SOLUTIONS

Two often-proposed methods of aiding the central city are the formation of a metropolitan or regional government and the sharing of revenue by the state or Federal Government. Either method can achieve the goal of relieving the fiscal pressure on central cities, but each also has shortcomings.

Metropolitan Government: A Loss of Competition. A metropolitan government consists of a central city and all of its suburbs replacing many local governments. Proponents of this approach argue that it would eliminate competition for the tax base at the local level.[6] Individuals or businesses would have to move outside the metropolitan area to escape paying their share of taxes. The problem with this solution is that local government competition can be desirable.

Local government, locally financed, is beneficial in two important respects. The first is that to some extent it forces people to reveal what they are willing to pay for government services. Suppose property taxes were used only to finance goods and services whose costs are approximately proportional to the amount of property people own. It is then likely that the "shopping" element of community choice would direct people with similar preferences for government services to the same communities. They would not have any incentive to move to communities that provided more of these services than they wanted because they would have to pay the cost. Similarly, people would not have an incentive to move to communities providing too little of these services because the resultant tax savings would not compensate them for having less of these services.

The second benefit (and perhaps that which advocates of local government stress most) is the wider range of choice which results from many "suppliers" (governmental units). For example, suppose that Jones would like more police protection than would Smith. If they live in the same community, both cannot be satisfied. Voting may lead to some compromise, perhaps less than Jones would like to "purchase," but more than Smith wants to pay for. However, if Jones and Smith each move to other communities populated with residents of similar tastes, each may be able to achieve his desired level of police protection. A more inclusive metropolitan government is not likely to offer as much variety.

This is not meant to imply that local government would not have fiscal pressures in the absence of local income redistribution. Most economists now agree that suburbanization would have occurred even if central cities had had no fiscal or social problems.[7] Also, people in every community will want to

[6]There are a number of arguments related to coordinating the actions of local governments which are also expounded by proponents but which will not be covered here. For a discussion of these arguments and alternative forms of metropolitan government, see L. Christine Grad, "Blueprint for Metropolitan Reform," *Business Review* of the Federal Reserve Bank of Philadelphia, October 1971, pp.12–17.

[7]For example, see Edwin S. Mills and James MacKinnon, "Notes on the New Urban Economics," *Bell Journal of Economics and Management Science* 4 (1973): 593–601, 596.

minimize their costs for particular services. But this type of incentive serves to inform government of what the residents want. In this case, a community may lose residents by not providing the desired level of services or by being inefficient, but it will not lose residents because another community is a "tax haven."

Sharing Revenue Distorts "Prices." The sharing revenues approach leaves government units unchanged but provides funds from state or Federal sources to relieve the fiscal pressure on local government. Tax collections are made from all over the state or even the country, making tax avoidance very difficult.

Sharing revenue has been with us for some time, although large-scale transfers of unconditional funds are relatively recent occurrences. Table 5 shows that funds from the state and Federal governments have been growing faster for Philadelphia than for any of its neighboring Pennsylvania counties. In fact, while Philadelphia had the largest percentage increase in expenditures, the growth of transfer funds has been sufficient to give it the smallest percentage increase in taxes and in total revenue from local sources. Thus, sharing revenue has, indeed, relieved some of the fiscal pressure on central cities and other local governments. However, this solution also has a drawback.

Revenue sharing does not force people to relate their tax payments to the cost of providing services. If one community should consistently get more in transfer funds than another, it will become more attractive relative to the second community. In addition, each community will still have incentives to attract businesses and individuals who pay more in taxes than it costs to serve them and to keep others out. Because the "prices" of services in one community versus another still do not reflect the cost of resources used in providing these services, people will expend time and money in relocating. Moreover, they will not move to the community which can best satisfy their preferences with the least use of resources.

LOCAL FINANCING WITHOUT INCENTIVES TO MOVE

It may sound like local tax financing will always create incentives for people to separate into similar income groups, but this is not true. This result arises from attempts to redistribute income locally through the tax process. If Smith's taxes represent the cost of serving him, then it doesn't matter much to the community whether or not he lives there. Neither a new rich neighbor nor a new poor one would alter the taxes or benefits for current residents of the community. For example, if the property tax were restricted to financing services whose cost is approximately proportional to the amounts of property in the community just as the property tax is, then people with large houses would have no *tax* incentive to bar construction of small houses. Such services as fire protection are likely to fit into this category. Thus, owners of large houses on large lots (which are likely to require more fire equipment and create a bigger area to cover than do small houses on small lots) would pay higher taxes to offset the higher costs imposed on the community. No doubt there are other reasons why people might want similar houses in the same community (such as aesthetic appeal and a desire to socialize with people of similar income), but such considerations often relate more to an immediate neighborhood than to an entire town.

When a government service has costs which are not related to property, then the property tax should not be used for financing. Similarly, if the cost of serving someone is not related to his income, then a local income tax should not be used to finance that service. Certainly, we would seldom expect to find an exact correspondence between a certain tax and the cost of providing a particular service. But now taxes and services are usually completely unrelated. Take welfare as an example. Most people agree that society has some obligation to care for the indigent, but why should the burden fall on property owners in a particular community? This is definitely an area where direct payments from the Federal Government would lead to more equal treatment for the poor in different communities and would relieve an unfair burden on city property owners. This proposal would, in turn, reduce the incentive to move strictly to avoid local tax payments aimed at redistributing income.

Another benefit of such a system is that the range of choices available to many people would increase. Education is a good example. "Charging" on the basis of the number of schoolchildren avoids income redistribution at the local level. Given that government has assumed the financing of the service, the funds should come from state or Federal sources. One way would be for the state to issue a voucher which would be used to "pay" for schooling.[8] Each student would receive a voucher and present it to the school he attends. The school would then redeem the voucher with the state or Federal government for its operating funds. Local communities might continue to *provide* school services, but there would no longer be any reason to restrict entrance to local residents. Thus, a family would not have to relocate to obtain the educational services it desires.

In short, let local government continue to finance those services which do not result in significant income redistribution. And, whenever possible do this with taxes that closely reflect the costs of providing services. Let the state and Federal governments finance services which entail significant income redistribution. Income redistribution can be more effectively administered at these higher levels of government. The difficulty in avoiding broader-based taxes will reduce the amount of resources spent in trying to avoid them. At the same time, the benefits of local choice can be maintained or increased.

SUMMING UP

Now, what about that "fiscal crisis"? To the extent that such a crisis exists, it is at least partly caused by communities using local taxes to finance public goods and services in such a way that some redistribution of income results. When this effect is large, communities are forced both to compete for citizens who make a net contribution to the local treasury and to keep out those who are a net drain. This can lead to segregation by income, and it's possible for this to make everyone, including the poor, worse off than if no such attempt were made.

The benefits of many communities offering a range of services are very real. Financing the wrong services—ones where taxes are not linked to costs—by means of local taxes is likely to cause inefficient use of resources and excessive decentralization of people and businesses. It is time for a rational approach to financing government expenditures, and this includes a recognition that efficiency and equity may require one level of government to raise taxes while another provides goods or services. However, it also requires the recognition that competition at the local level can be beneficial. There is no reason for city governments to be spared from having to accept the tradeoff of taxes and services faced by other governments. But there is also no reason for them to shoulder most of the burden of financing services for the poor.

[8]The voucher plan allows parents to determine what school to send their children to while having the state continue to finance the education. See David W. Lyon, "Capitalism in the Classroom: Education Vouchers," *Business Review* of the Federal Reserve Bank of Philadelphia, December 1971, pp. 3–10.