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MUNICIPAL REVENUES AND LAND POLICIES

Edited by Gregory K. Ingram and Yu-Hung Hong

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PREFACE

Although much public discourse about the effects of the 2008 financial crisis on government finances focuses on federal and state budget deficits, most of us experience actual impacts at the municipal level, where governments clean streets, repair roads, fight fires, prevent crime, and maintain the water and sewer systems. What will happen if municipalities are no longer financially able to provide daily public services to their constituents? In principle, state governments are obliged to transfer funds to cities to cover their budget deficits because they created the municipalities to fulfill these public service responsibilities. However, the states themselves have huge budget deficits, so most municipalities need to deal with their financial problems themselves. In an attempt to expand own-source revenues, cities are facing voter resistance to tax and user fee increases. Curtailments in local services will adversely affect residents' welfare and may lead to labor and capital out-migration.

To explore municipal revenue options during a severe economic downturn, the Lincoln Institute of Land Policy held a conference in June 2009 to discuss selected fiscal instruments for financing local services and infrastructure. Public finance experts with backgrounds in economics, law, planning, and political science were invited to exchange ideas. This book summarizes the analyses and proposals of the conference participants.

Seven preliminary ideas emerged from the discussions at the conference and the chapters and commentaries in this volume. First, there is no single or fast way for municipalities to reduce their fiscal shortfalls. Because the recovery of the U.S. economy and improvements in municipal fiscal conditions will be slow, cities should not just focus on short-term deficit reduction. Instead they should initiate long-term rehabilitation of municipal finances.

Second, fiscal remedies must not undermine the economic foundation of the city and local tax bases. Municipalities may consider using development impact fees that enable them to negotiate with investors for self-financing local developments to expand local tax bases.

Third, the property tax should be strengthened because this local revenue source is more stable than local sales and income taxes. In reforming real property taxation, a split-rate property tax system that can improve land use efficiency by taxing land more than buildings and that will cause little migration of the tax base should also be considered.

Fourth, tax hikes should be tied to service improvements. This linkage can help persuade taxpayers to pay higher taxes for municipal services during financially challenging times. Methods such as tax increment finance and community facility districts could be used to strengthen the nexus between government spending and revenues.

Fifth, long-term infrastructure investment should be financed by public debt to match actual consumption and payments for services. Yet, the use of debt financing should be transparent, and it should be scrutinized by state and local residents.

Sixth, business improvement districts may help alleviate part of the service responsibilities of the city by providing services that supplement local public goods. The government will continue to supply citywide services, but it needs to also allow local commercial districts to provide additional services in their neighborhoods.

Seventh, inter- and intragovernmental collaboration matters. Municipalities may negotiate with higher-level governments to align their expenditure and revenue assignments. They should also work collectively with federal and state policy makers to ensure that their interests will be accounted for when designing nationwide fiscal reforms.

These ideas represent promising areas based on recent research and policy analysis. As is the case with any suggested solutions for intricate policy issues, they need to be adjusted according to local circumstances.

The publication of this book involved the aspirations and efforts of many people. At the heart of the book are the assessments and recommendations presented by the chapter authors and commentators. We are grateful for their willingness to share their insights and knowledge with us. We thank Diana Brubaker, Jeffery I. Chapman, Gerald Korngold, Andrew Reschovsky, and Joan Youngman for their assistance in the design of the conference and suggestions on speakers and discussants. No conference can be successful without the endless efforts of a planning team. We appreciate the logistical support provided by Melissa Abraham, Brooke Digges, and Rie Sugihara. We are fortunate to work with a very proficient team of editors and graphic designers that comprises Nancy Benjamin, Carol Keller, Sybil Sosin, and Vern Associates. Special appreciation is given to Emily McKeigue for managing the team and the entire editing and publication processes.

Gregory K. Ingram
Yu-Hung Hong

Municipal Revenues and Land Policies

The Importance of Municipal Finance

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Municipal Revenue Options in a Time of Financial Crisis

Gregory K. Ingram and Yu-Hung Hong

The 2008 financial sector meltdown was the worst economic downturn since the Great Depression. In the United States, the federal government implemented the unprecedented $700 billion Troubled Asset Relief Program and the $787 billion American Recovery and Reinvestment Act to unfreeze credit markets and resuscitate the economy. Despite this large outpouring of public funds, corporate bankruptcies and high unemployment rates have persisted. While the financial ills hampered private investment and employment growth, they devastated state and local government finances. According to McNichol and Johnson (2009), 47 states had to compensate for financial shortfalls totaling $158.5 billion before adopting their 2010 budgets. Among these states, California had the largest fiscal gap of $45.5 billion, about 44 percent of its total general funds. In Arizona, where property foreclosures spiked, the state faced a total deficit of $5.2 billion—over half of its total budget. Many other state governments cut public spending, postponed infrastructure projects, and had state employees take unpaid furlough days in order to shore up fiscal systems weakened by deficit and debt. Although there were hopeful signs that the financial crisis had been stabilized by the end of 2009, public finance experts predicted that the difficulties for state and local governments were far from over (Hoene and Pagano 2009; Muro and Hoene 2009).

In particular, the outlook for municipal governments is grim. In a 2009 survey of city finance officers, 88 percent of respondents indicated that their cities were unable to meet the current year's financial needs (Hoene and Pagano 2009). While spending in U.S. cities increased by an average of 2.5 percent, revenues dropped by 0.4 percent. Because municipalities rely on the property tax and assessments lag the market, the study also predicted that depressed real estate values will continue to undermine local fiscal health in 2010 and 2011. The federal and state governments may not be able to come to the rescue as they try to reduce their own budget deficits. The prospect for municipalities to increase local taxes and/or cut public spending is low because of the recession. All these unfavorable conditions undermine the solvency of municipal governments.

The chapters in this volume explore various municipal revenue options in the face of fiscal stress. They were generated from the 2009 land policy conference organized by the Lincoln Institute of Land Policy. Besides providing detailed analyses of municipal revenue sources, the contributors to this volume have examined the viability of selected local tax and nontax instruments as potential solutions to municipal fiscal shortfalls. The chapters are grouped in six sections:

- The importance of municipal finance
- Intergovernmental transfers and municipal fiscal structures
- Broad-based local taxes and development impact fees
- Financing submunicipal services
- Capital financing of infrastructure
- Comparisons of the property tax with other revenue instruments

This introduction summarizes the key arguments of the chapters and commentaries that make up each of these sections. At the end, we synthesize the ideas proposed by the contributors that may be used by municipalities to deal with their budget crisis.

The Importance of Municipal Finance

Cities and their surrounding suburban neighborhoods are economic growth agents. Not only do they provide public goods to satisfy the needs of urban residents, but they also supply local infrastructure to facilitate local and regional economic development. As Robert P. Inman argues in chapter 2, urban services and infrastructure must be efficiently provided; if they are not, the city's economy will suffer from labor and capital flight, causing losses in productivity. Cities need to create the right incentives for service providers to pay close attention to the preferences of households and firms and the efficient provision of public goods. Inman discusses three conditions for achieving this goal.

First, city managers must get their fiscal responsibilities right. They should provide services that the private market cannot provide efficiently due to large fixed costs and benefit spillovers. These services include education for general skills, local transit and roadways, sanitation, and public safety. Income redistribution and internalization of spillovers that have significant spatial scale should not be included in the agendas of city governments.

Second, local service provision and taxation must be connected. Inman argues that cities should not collect nonresidential commuter taxes, local retail sales taxes, or business income (or gross receipts) taxes to fund residential services. Rather residential wage taxes and user fees should be used to finance residential services. Ideally, a business land tax and user fees should be used to finance business services. For infrastructure services, long-term debt financing is the right tool.

Third, city governance matters. Cities need managerial control over their workers to avoid the monopoly power of public unions over local service provision. A strong mayor who can discipline narrow-interest politics and labor unions may, however, make inefficient fiscal choices. Council governance could be an alternative institutional arrangement, but might also create political gridlock. In either case, citizens must be motivated to remove from office officials who waste tax dollars. Implicit in Inman's discussion is that city governance reform could enhance efficiency, allowing cities to provide the same level of local services at lower costs. As more believe "a crisis is a terrible thing to waste," the current fiscal crisis may create an opportunity for city officials to reexamine their spending and revenue-generating practices.

Intergovernmental Transfers and Municipal Fiscal Structures

One often-anticipated solution for closing municipal fiscal gaps is to increase federal and state government transfers to cities. David E. Wildasin examines this possibility in chapter 3. Under U.S. fiscal federalism, higher-level governments have no obligation to provide financial assistance to local governments in times of fiscal distress. The only exception is the federal emergency relief funds sent to state and local government to deal with natural or economic disasters. The reason behind the lack of obligation to provide financial assistance is that central support could pose a risk to the fiscal stability of both the donor governments and the recipients. The key concerns are moral hazard and softening of local budget constraints.

An examination of data from 1997 to 2005 reveals no evidence of significant increases in federal or state intergovernmental transfers to localities during recessions that lasted for six months or longer. State government transfers stayed at 35 percent of total local general revenue during this period, and cities and counties received about half of all state aid to local governments.

Although direct transfers from the federal government have not been a significant source of local public funds, the federal government plays an important role in establishing tax exemptions that reduce borrowing costs for subnational governments. In addition, federal tax exemptions for state and local income and property taxes may boost housing and commodity consumption, thus increasing revenue from local sales, income, and property taxes. Federal aid through the Social Security, Medicaid, and food stamp and other welfare programs can also help to stabilize economically distressed areas.

Wildasin asserts that in the past adverse local fiscal conditions have not burdened the federal and state governments. He examines a panel data set of 1,000 municipalities over more than a quarter century and finds that city officials adjusted over time to long-term budget constraints, resolving their fiscal shortfalls by either increasing own-source revenues or decreasing spending. Although intergovernmental transfers did absorb some fiscal shocks, they played only a minor role in the adjustments.

Besides mitigating fiscal imbalances, intergovernmental transfers are employed to stimulate spending during economic downturns. Michael Smart, the commentator on chapter 3, argues that the effectiveness of stimulus policy is low. First, evidence indicates that local spending adjusts to changes in grants slowly because modifying spending at local levels takes time. Second, owing to the transitory nature of stimulus programs, local governments may anticipate future reductions in intergovernmental transfers, therefore saving a portion of the available funds to cover future spending. In sum, both Wildasin and Smart predict minor impacts of intergovernmental transfers on local government revenues and expenditures. Although intergovernmental transfers account for more than one-third of total local budgets, moderating the current local fiscal crisis by expanding this revenue source is unlikely. Municipalities will likely have to depend on an expansion of own-source revenues and/or cuts in local services to balance their books.

Because local fiscal structures in the United States are diverse, could the above conclusions be applied generally to both large and small municipalities across regions? J. Edwin Benton examines this question based on revenue data from 1962 to 2002 for counties, special districts, school districts, municipalities, and townships. We summarize his findings for municipalities here, and information about revenue structures for other local government units is in chapter 4.

Table 1.1 shows that in 2002 over 40 percent of the total general revenue of cities in the New England and Mid-Atlantic regions came from intergovern-

Table 1.1
Municipal Revenue Structures by Region, 2002 (percent of general revenue)

	Intergovernmental Transfers	Own-Source Revenues			
		Total	Local Taxes		User Fees and Charges
			Property Taxes	Other Taxes	
New England	44	56	43	0	13
Mid-Atlantic	42	58	20	22	16
North Central	28	72	20	19	33
South	23	77	21	21	35
West	21	79	16	27	36

Source: Benton, chapter 4, tables 4.1 and 4.4.

mental transfers (largely state aid), compared to less than 30 percent for their counterparts in the North Central, South, and West. This means that cities in the North Central, South, and West relied more on own-source revenues, especially user fees and charges (over 30 percent of total revenue) to cover local spending. Although the property tax share declined significantly between 1962 and 2002 for all types of local government (see chapter 4, table 4.3), for New England cities, property taxes totaled 43 percent of general revenue in 2002 in contrast to cities in other regions, where property taxes accounted for 16 to 21 percent. One reason for the heavy reliance of New England cities on property taxes is that they did not collect any local income or sales taxes. Conversely, cities in other regions obtained from 19 to 27 percent of their total revenue from these local taxes.

Table 1.2 illustrates 2002 municipal revenue structures by population. Large cities (with populations over 300,000) obtained more financial support from state governments than did their smaller counterparts. Own-source revenues made up 77 percent of the budgets of the smallest cities (those with fewer than 25,000 residents). Among the various own revenue sources, large cities depended less on property taxes and more on other local taxes and user fees. User fees and charges were the most important revenue sources for small cities. The smaller a city, the larger the percentage of user fees and charges in total revenue.

Based on his analysis, Benton suggests that local governments in general should use charges for services to generate additional revenues. This is especially true for cities in the North Central, South, and West, where user fees and charges have been the main sources of local public funds. State governments in these regions have also been more amenable to allowing local governments to expand the use of local sales and income taxes and user fees. Cities in regions where anti–property tax sentiment is strong should renew their efforts to secure more state aid and/or utilize local sales, gasoline, and income taxes. With constitutional limits on property tax collections, rate increases, and assessed values, the possibility of expanding this revenue source is low. Finally, if revenues from user

Table 1.2
Municipal Revenue Structures by Population, 2002 (percent of general revenue)

	Intergovernmental Transfers	Own-Source Revenues			
		Total	Local Taxes		User Fees and Charges
			Property Taxes	Other Taxes	
300,000 or more	34	66	16	25	25
100,000–299,999	30	70	22	19	29
25,000–99,999	25	75	25	20	30
Under 25,000	23	77	23	19	35

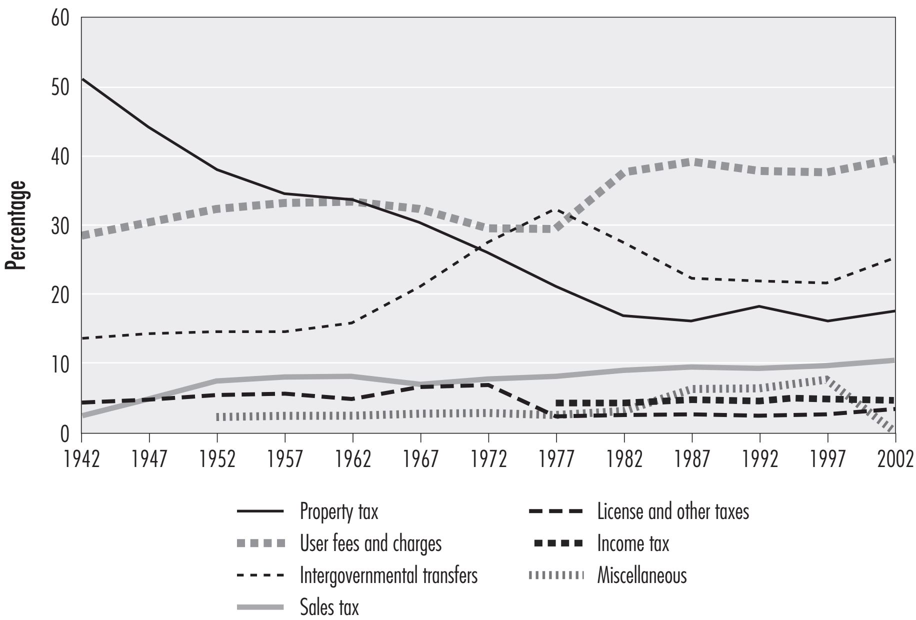
Source: Benton, chapter 4, tables 4.2 and 4.5.

fees falter as the economy remains weak, cities may have to contract out more services to private and nonprofit vendors, renegotiate service responsibilities with the state and other levels of government, or utilize more volunteer labor. Like Inman, Benton also proposes to overhaul local government management practices to enhance productivity.

Although Jocelyn M. Johnston agrees with Benton that user fees will continue to be the most important source of local revenue, she questions the implications of this trajectory on equity grounds. Charges for services and the local sales tax are more regressive than the property tax, Johnston asserts. These revenue instruments may also reduce the stability of municipal finances due to economic fluctuations. Her challenges are examined in detail when we discuss local sales and income taxes and development impact fees.

Michael A. Pagano, the author of chapter 5, concurs with Benton that U.S. municipal fiscal systems are diverse and that different approaches are required to handle their fiscal problems. Based on a historical analysis of general municipal revenue patterns from 1942 to 2002 (see figure 1.1), he suggests different scenarios for urban fiscal policy. Property taxes were the main source of municipal funds

Figure 1.1
Shares of Municipal Revenues by Source



Note: The numbers for 1947 are the averages of the 1942 and 1952 figures, because the 1947 data are unavailable.
Source: Pagano, chapter 5, table 5.1.

in the early 1940s, accounting for over half of total revenue. Their importance decreased in the next 30 years as cities diversified their tax bases to include retail sales taxes and received large amounts of federal funding for urban renewal.

The declining share of property taxes in total revenue continued in the 1970s, with the tax revolt adding additional pressure on cities to shift to alternative revenue sources. Federal aid also decreased in the late 1970s following the oil crisis and the stock market crash. With the decline of these two revenue sources, incomes generated from user fees and public enterprises provided the key funding for municipal services and infrastructure. By 1982 user fees and charges were nearly 40 percent of total general funds, whereas property taxes and intergovernmental transfers were only 17 and 27 percent, respectively. The general revenue pattern for municipalities remained stable from the early 1980s on, with user fees and charges as the largest source of municipal revenue. This general trend notwithstanding, Pagano argues that it is difficult to design a single fiscal solution for all U.S. cities due to their heterogeneous fiscal structures. Some cities rely on just one tax source, while others depend on two or three different taxes to finance local services (see chapter 5, figure 5.2).

In reviewing approaches that cities may use to handle their budget deficits, Pagano asserts that the property tax might not act as a countercyclical revenue source in this recession because, unlike during other economic downturns, collections will decline. The slowdown of real estate markets that began in 2007 has caused decreases in property tax collections since fiscal year 2008, given the lag in tax assessments. If real estate markets do not recover in 2010, declining housing values will continue to reduce property tax revenues until at least 2011. This trajectory is problematic for cities because sales and income tax receipts also decreased in fiscal year 2009 and may continue to fall in 2010.

With projected reductions in tax revenues, some cities may increase their charges for local services. Pagano argues that user fees face less public resistance because their collection method is based on consumption, and they are thus perceived to be efficient and equitable. Pagano also believes that cities should explore the possibility of regional tax-base sharing such as common-pool funds for neighboring jurisdictions. His other proposals include (1) broadening the sales tax base to include services; (2) restructuring the property tax from a uniform to a split-rate system; (3) focusing on tax bases that have closer links to the local economic base; and (4) collaborating with regional partners to minimize adverse effects of interjurisdictional tax competition and spillovers.

In response to Pagano's suggestions, Carol O'Cleireacain cautions that municipalities may not have the discretion to determine their financial future. The feasibility of regional tax-base sharing (or service sharing) and the consolidation of urban neighborhoods into one governance unit would depend on the political environment of the state. She also argues that there are limits on fee increments. For example, in New York multiple increases in water service fees eventually made the marginal rate adjustments look excessive, thereby engendering public resistance. Owing to her reservation about regional tax-base sharing and user fees, O'Cleireacain is hopeful that the federal government will help restore the fiscal health of cities.

Broad-Based Local Taxes and Development Charges

If expanding user fees is not viable, as O'Cleireacain argues, would adopting or increasing local sales and income taxes in municipalities where these taxes are allowed be a possibility? John L. Mikesell, in chapter 6, analyzes the local sales and income taxes in several U.S. states. As of 2009 the local sales tax is levied in 36 states, constituting over 30 percent of total local tax revenue in some of them. In contrast, only five states (Kentucky, Maryland, New York, Ohio, and Pennsylvania) collect local income taxes, which generate over 15 percent of local tax revenue. Among all levels of local government, municipalities are the heaviest users of local sales and income taxes. Over three-quarters of all local income tax collections and nearly 60 percent of all local sales taxes go to municipalities.

In aggregate, however, local sales and income taxes are not key municipal revenue sources (see figure 1.1). Several drawbacks lead to their infrequent use. First, some local income taxes have a flat rate and a base that excludes interest income, dividends, and capital gains, making their tax burden regressive. Second, cities that collect local sales or income taxes are competing with federal, state, and counties for the same tax bases. The overlapping of tax bases can lead to high combined marginal rates when the federal, state, and other local government rates are added together. Third, local sales tax is sensitive to interjurisdictional competition. Previous studies estimate that a 1 percent rate differential in local sales tax leads to a 3 to 7 percent decrease in retail sales.

Despite these potential problems, could the two local taxes provide additional income for municipalities in times of fiscal stress? To answer this question, Mikesell compares the buoyancy, stability, and horizontal equity of the local property, income, and sales taxes, using data for local governments that collected $1.5 billion in revenue from the local income tax, local sales tax, or both for fiscal years 1985 to 2006. He argues that if a revenue source grows steadily but slowly, it would not be useful to local governments for closing fiscal gaps during a recession. He finds that property tax collections grow more slowly but more steadily than sales and income tax revenues. Although sales tax revenue has the fastest growth rate, it is the least stable of the three taxes. In terms of reducing horizontal fiscal imbalance created by the property tax, no evidence of superiority of the income or sales taxes is found. Based on these results, Mikesell concludes that municipalities could increase revenue by adopting or increasing the local sales tax, but this would make their revenues less stable and fiscal capabilities across cities more disparate. No conclusion can be drawn for the local income tax because only a few cities have adopted this tax.

Commenting on Mikesell's analysis, Cynthia L. Rogers stresses that not all local jurisdictions that have the discretion to levy local sales taxes have fully exercised this power. This reflects reservations about adopting the tax, such as distance to the nearest regional shopping center and sales tax rates set by the state and adjacent governments, factors that are normally not under the local jurisdictions' control. She also suggests searching for an optimal mix of local taxes that can enhance the buoyancy and stability of local revenue systems. Unlike Mikesell, Rogers is less concerned about fiscal disparity across jurisdictions, which she sees as a reflection of differences in local preferences. She argues that government actions are not required unless the desired services are not provided. In sum, both Mikesell and Rogers imply that local sales and income taxes are not perfect fiscal solutions.

Their conclusions lead us back to user fees and charges. Among such levies, development impact fees have become most popular in U.S. cities. These fees are one-time levies assessed on developers during the permitting approval process. Revenues generated from impact fees are normally used for investments in specific facilities such as roads, parks, public utilities, schools, and libraries. Impact fees have the potential of making urban development pay for itself, thus imposing few negative externalities on existing residents. Gregory S. Burge examines their direct and indirect fiscal impacts in chapter 7.

The principle behind impact fees is to assign the costs of infrastructure requirements for new development to the parties that generate the need (the so-called rational nexus). Due to this linkage, the direct fiscal effects of impact fees come from revenue increases generated from fee collections and additional expenditures on infrastructure development. If the total amount of impact fees collected equals the total cost of facility investment, the net fiscal effect will be neutral. Burge argues that impact fee levels in the majority of communities examined in previous research are set at or below the full marginal cost of infrastructure construction. Thus, subsidies are normally required for new development. Certainly, had there been no impact fees, public subsidies would have been ever larger, adding more pressure on local budgets that are already under stress. Besides, savings from subsidies could be reallocated to finance other local services.

The indirect fiscal effects of impact fees operate primarily through their influences on the property tax rate and base. Critics of impact fees argue that these development charges discourage economic development and stifle employment, which can lower the demand for residential and commercial properties. Weaker demand will cause housing values to drop and shrink the property tax base. If the tax rate remains unchanged, total tax collections will drop.

As Burge asserts, many existing studies have shown that residential impact fees increase property values, with new and existing homes experiencing a similar price effect. Specifically, nonutility impact fees have significant positive effects on job growth and the construction rates of larger single-family units in inner and outer suburban areas. With the increase in the supply of residential and nonresidential units of higher value, the property tax base expands. As the tax rate adjustment lags behind the rise in property values, ceteris paribus, property tax collections increase. Conversely, commercial impact fees tend to discourage development and employment, thereby lowering investment and the supply of commercial properties. With fewer commercial properties but a rise in their value due to the decrease in supply, the fiscal effect of commercial impact fees is ambiguous. On balance, Burge asserts, impact fees should be able to augment local revenue. The key to this argument is that cities must substitute monetary exactions for other growth regulations to facilitate new development and do not use impact fees as an additional restriction to curb growth.

Albert Saiz argues that evidence on using impact fees to replace other development controls is mixed. Although impact fees are found in fast-growing localities, one could argue that construction rates could have grown even more quickly had local governments waived development charges. The Wharton exaction index that Burge uses to support his argument is imperfect because it does not show impact fee levels. Saiz also finds positive relationships between the measure for exactions and other growth control indexes such as open space requirements, antigrowth sentiment, and the complexity of the development approval process. However, he does not dismiss the possibility that impact fees might have enabled developers to negotiate with city officials on development proposals that would have been rejected outright in the absence of the option.

Some municipalities in Brazil also ask developers to compensate the city for the cost of infrastructure needed to support new development. Paulo Sandroni discusses in chapter 8 a new instrument called the certificate of additional construction potential (known in Brazil as the CEPAC). The principal idea of the CEPAC is to create development rights for upzoning and then to sell these rights to developers to raise funds to finance infrastructure construction. The total number of CEPACs, which is capped by law, is determined by the municipality. CEPACs are auctioned off by the Federal Bank of Brazil and can be used only in a designated urban operation area that a city government has targeted for public investments.

Sandroni states that CEPAC revenue provides municipalities with the initial capital for infrastructure investment. From 2004 to 2009 the total income collected from selling CEPACs in Faria Lima and Agua Espraiada, São Paulo, was R$1.62 billion (US$812 million). Municipalities also use CEPACs to pay their contractors. Developers benefit from CEPACs as well. They are no longer required to undertake their development projects immediately after the acquisition of building rights. Instead, they can decide on the timing of their investments according to market conditions.

These benefits aside, implementation is not problem-free. The first auction of CEPACs in Faria Lima was delayed because the city council was concerned about possible increases in municipal indebtedness. When the auction finally took place, only a small number of CEPACs were sold because the minimum price was set too high. Many developers had accumulated building licenses before the commencement of the new system. Some reallocated their investment capital to

Agua Espraiada, where comparable CEPACs could be obtained at lower prices. The implementation was also adversely affected by the downturn in the housing markets and the change of city administration.

Although Sandroni believes that CEPACs could improve the revenue-generating capacity of São Paulo in the long run, he questions whether similar systems could be adopted by cities in the United States and elsewhere. Considerations abound. First, certificate holders may bear high financial and regulatory risks due to changes in the certificate prices and land use regulation. Second, a secondary market for trading certificates could take a long time to develop. Third, selling development rights can be lucrative only for cities whose property markets are buoyant. Fourth, considerable financial expertise is required to administer the system.

Margaret Walls identifies a key difference between CEPACs and two U.S. development charges (impact fees and transferable development rights). While the former increases the density of development, the latter instruments keep construction from going beyond what zoning allows. Would CEPACs create the wrong incentive for the city to lower planning standards simply to generate revenues? Walls suggests more in-depth research on this issue.

Financing Submunicipal Services

There have been attempts to expand the principle of charging for services to additional public goods. These approaches include business improvement districts (BIDs), tax increment financing (TIF) districts, homeowners associations (HOAs), and community facility districts (CFDs). They are normally carried out in a designated area (or district) where members of a community who finance the public goods can exclude nonmembers from using the services. In essence, the excludability of local services by the community turns the public goods into club goods. These submunicipal service systems (or governments) are analyzed in chapters 9 to 12.

As Inman suggests in chapter 2, the integrity and effectiveness of a public administration will affect revenues and spending. This issue is especially relevant for submunicipal governments because of their ability to raise capital from financial markets without state government constraints and public scrutiny. Submunicipal governments are established or chartered by the state or city and operate like private corporations with oversight boards. They have the authority to adopt corporate names, make bylaws, establish offices, and bear legal liability independently.

Owing to these unique arrangements, the governance structure of a submunicipal government has an important bearing on its financial management and in turn on the city budget. In chapter 9 Robert J. Eger III and Richard C. Feiock evaluate the impacts of the governing board's structure on both revenues and expenses, focusing on three factors: (1) the size of the governing board; (2) the degree of board professionalization (measured in terms of whether members are full-time or salaried); and (3) the number of elected and appointed members on the board. They use a random effects regression model and a panel data set for submunicipal governments from 1970 to 2002 to analyze these issues.

Eger and Feiock find that only appointed members have a significant positive relationship with intergovernmental transfers. Board size and professionalization have no significant effect. They explain these outcomes as a result of the inability of submunicipal governments to influence higher-level governments' budgets.

Expanding the size of the board and the number of appointed and salaried part-time members will increase own-source revenues. Full-time boards, however, decrease own-source revenues. This may be because salaried board members focus more on the ability of the organization to generate funds. Having a large number of board members on the payroll will also increase operating expenses, thus rendering the net financial impact ambiguous. An increase in the appointment of non-Hispanic white members seems to reduce own-source revenues, an outcome that needs to be explored in future research.

Richard Briffault cautions about generalizing Eger and Feiock's findings because of the heterogeneity of submunicipal special districts, with functions ranging from building cemeteries and libraries to providing housing services and flood control. He also indicates that there are big differences between board members elected by voters and those elected by landowners. To complicate matters further, board members can also be appointed by state or city officials, or both. These distinctions need to be accounted for and could lead to significant differential fiscal impacts on submunicipal government finances. As well, Briffault questions whether the causality between the board structure and own-source revenues asserted by Eger and Feiock may be reversed. It is possible that the overlapping state and city governments want to appoint more part-time representatives to the board of an expanding submunicipal entity in order to exert additional control over its budget and operation. It is also possible that a submunicipal entity that is less able to generate own-source revenues will need a large and full-time board to help with fundraising. Last, Briffault attributes the origin of special districts to municipalities' intention to circumvent state constitutional limits on their indebtedness and taxation rather than efficiency.

Among the different types of submunicipal governments, BIDs have become increasingly popular in the United States and elsewhere. According to Leah Brooks and Rachel Meltzer (chapter 10), there were about 7,000 BIDs operating in 400 U.S. cities in 2008. A BID can be initiated voluntarily by property owners in a commercial district who want to improve local public goods such as security, street cleaning, and marketing. When the BID is formed, it acquires the authority to tax all property owners, including dissenters, to finance service improvements. BIDs may affect the fiscal health and behavior of their home municipality in three scenarios: (1) BIDs' services are substitutes for municipal services; (2) their services are complements; and (3) BIDs increase their proportion of the tax base. Due to data limitations, Brooks and Meltzer run simulations using estimated data about the number of BID firms and total BID spending for 275 cities. Because their model relies heavily on information from New York City and Los Angeles, they simulate only upper-bound impacts.

Their simulation results show insignificant impacts of BIDs in all three scenarios. When BID services replace municipal provisions, the reduction in public spending is estimated to be small and has little welfare impact on nonBID members. When the public goods supplied by BIDs and municipalities are complementary, public spending on BID properties is estimated to be higher than on nonBID properties. The differential is small (about 3 to 5 percent of public spending per establishment), causing no significant impact on total municipal expenditures. In estimating BID effects on local tax bases and revenues, Brooks and Meltzer project that BIDs could increase total sales tax revenues by about 2 to 5 percent. They add no more than 7 percent of property taxes to total collections. BIDs do shift tax liabilities from nonBID to BID members. But the calculated impact is less than 5 percent of the average tax liability of the nonBID firms. Overall, simulation results suggest that BID impacts on expenditures, revenues, and tax shares between BID and nonBID members are negligible at the municipal level.

Lynne B. Sagalyn stresses that BIDs function as suppliers of public goods to targeted districts; thus it is reasonable to expect them to have scant citywide fiscal effects. A study at the neighborhood level may reveal more significant impacts. She also believes that whether BID services will replace or complement municipal services depends on their collective political power. If they are well-organized and can lobby the city to provide public goods that enhance the benefits of their own provision, BID and municipal services will be complementary. Because of this dynamic, it is important to study the political economy of BIDs when assessing their fiscal ramifications.

Another approach that involves the designation of a special district to create a nexus between revenues and spending is the TIF. TIF districts are authorized in almost every state in the United States except Arizona. In 2007 there were about 291 TIF districts in 51 cities and four counties. Funding for TIF districts is mainly from property tax collections. In California, property taxes collected from TIF districts accounted for 10 percent ($2.1 billion) of the state's total property tax revenue in 2001.

The property tax base in a TIF district is divided into two portions. The first portion is the total assessed taxable property value at the time of designation. The second portion is the increment of the assessed value after the adoption of TIF. Property owners within the TIF district are required to pay the existing property taxes based on the first portion of the assessed value. They also pay additional taxes assessed on the second portion of the tax base at a rate that is the sum of the existing municipal tax rate plus the TIF rate. These collections will be retained by the district for financing economic development. David F. Merriman argues that the experience of the TIF is mixed. In chapter 11 he focuses on how TIF might add volatility to municipal budgets.

TIF will affect municipal revenues in two ways. First, when a TIF district is in operation, the municipality will lose property tax collections from that area because the tax base is frozen. All general increases in real estate value will be included in the TIF property tax base. Second, at the end of the TIF agreement, the entire TIF property tax base will go to the municipality as a one-time fiscal payoff. To measure how these arrangements may affect the revenue stability of cities that use TIF, Merriman simulates changes in the tax base of a municipality that has 20 neighborhoods, each of which has an equal chance of being included in a TIF district. The duration of the TIF district is 25 years. The model tracks the market value of properties in TIF and nonTIF neighborhoods for 100 years based on 1,000 simulations.

Assuming a uniform 6 percent growth of property values across TIF and nonTIF neighborhoods, Merriman finds that the average municipal tax revenue will slowly fall below 6 percent because the city does not have access to the increment within the TIF district. After 25 years, municipal revenue jumps about 15 percent as the city receives the entire tax base from the dissolved TIF district. Merriman then runs two sets of simulations with the TIF district growing faster than the surrounding neighborhoods. The first set assumes a causal relationship between TIF and the differential growth rate, and the second set supposes no relationship. In both cases, the decline in the municipal tax base is much more erratic than the changes predicted under the assumption of uniform growth. Based on these outcomes, Merriman concludes that TIF districts add long-term volatility to municipal budgets.

Mark Skidmore is less concerned about the volatility that TIF may add to municipal budgets because the changes of tax base can be anticipated. Thus, the fluctuation in revenues caused by tax base changes could be offset by tax rate adjustments. Using a two-way fixed effects regression model to analyze data from all municipalities in Wisconsin from 1990 to 2003, Skidmore finds unexpectedly that municipal tax rates decreased when the tax bases were frozen because of the adoption of TIF districts. The decline in municipal tax rates might have been due to the shift of city responsibilities to the overlying jurisdictions. Yet, more research is needed to explain this outcome. Skidmore's finding illustrates the dynamics and unpredictability of municipal budgeting and finance.

Like BIDs, the primary objective of HOAs is to provide their members with services that supplement the municipal provision. Access to HOA services is restricted to members only. Ron Cheung discusses how this form of submunicipal government affects municipal spending, revenues, and tax base in chapter 12. Based on a 30-year (1970–1999) panel data set for 110 California cities, he finds that increases in planned development (a proxy for measuring the presence of HOAs) lead to a small decline in public spending. A 10 percent increase in the number of planned development units decreases total expenditures by 1.51 percent. According to his regressions, the only service reduction that has a significant negative impact on nonHOA members is parks and recreation. As park spending is a tiny component of a local budget, the welfare losses for nonHOA members are likely to be small.

In terms of the impacts of HOAs on municipal revenue, Cheung finds that cities with fast growth in the number of planned development units experience a small decline in own-source revenues. He estimates that a 10 percent increase in planned development units per capita leads to a 1.7 percent drop in own-source revenues. In cities with a high level of planned development, the share of property taxes in own-source revenues dropped from 30 percent in 1970 to 14 percent in 1999. More reliance was placed on user fees and charges, with their revenues increasing by 0.5 percent for every 10 percent jump in planned development units per capita. Overall, the revenue impacts of HOAs are modest.

Regarding the secession of HOAs from the municipality, which will in turn shrink the municipality's tax bases, Cheung presents a detailed case study from California's San Fernando Valley. The case study shows that a high level of planned development can engender support for political secession. Yet, Cheung concludes that more research is needed to understand the causality.

John E. Anderson questions whether the growth of planned development units causes small revenue expansion, or vice versa. He cautions that lower spending does not necessarily mean lower quality of services provided, as the costs of public goods might have gone down during the study period. He also raises the issue of self-selection in the analysis of HOAs' effect on public support for political secession. To resolve these issues in Cheung's study, Anderson suggests developing a simultaneous model with interdependencies among municipal expenditures, revenues, and tax bases that can capture the simultaneity of these variables. He also believes that it is also important to explore the optimal quantities of club goods and an optimal club size for HOAs that could be used to delineate responsibilities between HOAs and municipalities.

Overall, chapters in this section illustrate the popularity of using submunicipal governments to supplement local services by club goods. Although the principle behind these instruments—clear linkage between revenues and spending—is attractive from an efficiency viewpoint, it is still hard to assess the actual fiscal impacts and welfare effects due to the lack of data. Yet, based on existing knowledge about these arrangements, BIDs and HOAs seem worthy of experimenting with if property owners decide to take charge of local services in the face of shrinking municipal budgets.

Capital Financing of Infrastructure

One of the most innovative areas in local public finance is debt financing of infrastructure. Creative off-budget debt instruments have been used to circumvent constitutional constraints on local governments' indebtedness. Skeptics argue that the ingenuity of local governments in exploiting private capital markets could lead to fiscal disasters. Chapters 13 and 14 examine private capital financing of public goods in detail.

Jeffrey Chapman examines certificates of participation, community facility district debt, and tax credit bonds in chapter 13. The certificate of participation (COP) is a financial scheme based on complex leasing agreements. It is usually used to finance the construction of public facilities such as prisons, courthouses, parking garages, and power plants. In 2008 over $13.1 billion of COPs were sold by 27 states.

There are two types of COPs. In an asset-transfer COP, a city issues a long-term lease (tantamount to a sale) of its asset to a private investor, who finances the transaction by borrowing funds from private credit markets, for a lump-sum leasehold payment. After the transfer of the property rights, the private investor will lease the asset back to the city for payments of annual rent. These leasing arrangements enable the city to tap private capital from the financial markets using the private investor as an intermediary. Because the city in principle is not the borrower, the debt created by the leasing agreement will not be reflected in its budget. The problem with this method is that any early termination of leasing agreements by contracting parties could cause the municipality huge financial losses, as happened in 2004 when the U.S. Treasury denied all depreciation deductions for sell-in-lease-out deals.

A COP for a construction project is more complicated. A public agency wanting to construct a facility enters into an agreement with an investor who will acquire or lease the required site from the government and build the facility. To finance the development, the investor will agree to lease the facility to the public agency upon completion of the project and assign the rights to receive future lease payments from the agency to a trustee. The trustee will then recruit an underwriter to sell these rights to interested buyers in the form of COPs that guarantee the receipt of future lease payments with a portion designated as tax-exempt interest. The proceeds from selling the COPs will then be used to pay for the project. Although COPs may raise capital for financing public facilities more quickly, their issuance costs could be higher than that of general obligation bonds because they are not backed by the full faith and credit of the government agency.

Like TIF districts, community facility districts are special submunicipal governments that have the power to tax property owners in the designated areas and to issue debt to finance public infrastructure such as parks, schools, libraries, public utility lines, and open-space facilities. To establish a community facility district, approval from two-thirds of the affected property owners is required. Bonds issued by the district are sometimes not rated or government insured, and thus bear higher interest rates. The exceptions are bonds issued by Mello-Roos districts in California that are secured by the unimproved site for the public facility construction. The repayment of the debt is by revenue generated from a special levy or tax imposed on property owners within the neighborhood. Unlike TIF districts, there is no overlapping jurisdiction in community facility districts, thus avoiding the complication of partitioning the tax base. More importantly, a neighborhood does not need to be declared to be blighted to form a community facility district.

Tax credit bonds allow a local government to receive immediate cash from issuing the debt but to repay the principal only at maturity. The federal government subsidizes the borrowing by paying 100 percent or less of interest for the security to bondholders in income-tax credits. Bondholders must report the tax credit as income, but can subtract the amount of the credit from the tax due. If there is no restriction on the use of the proceeds, the bond-issuing government can invest some of the proceeds from the bonds' sale for future repayment of the principal at maturity. Current tax-credit bonds operated under the American Recovery and Reinvestment Tax Act include qualified school construction bonds, clean renewable energy bonds, qualified energy conservation bonds, build America bonds, and recovery zone economic development bonds. Details of these debt instruments can be found in chapter 13.

Adding to Chapman's discussion, Mark D. Robbins and William Simonsen describe three more instruments: municipal bond insurance, variable rate debt, and interest rate swaps. These innovations are designed to lower the cost of financing public infrastructure investment. The municipal bond insurance is intended to enhance the credit rating of local government bonds by having a higher-rated company insure the debt. So long as the insurer maintains its credit rating, the municipality can issue bonds at a lower interest rate. Variable rate debts such as auction rate securities and variable rate demand obligations allow bond issuers to have a long-term obligation that carries short-term rates. Holders of these bonds have the option of tendering their securities back to the issuer prior to maturity and to demand payment for the outstanding principal and any accrued interest. The tendered securities will then be remarketed to interested buyers at a new interest rate set by auction. This debt instrument can increase the interest rate and remarketing risks for the municipal bond issuer, especially in times of financial instability. To hedge the interest rate risk, a municipality can enter into a "floating-to-fixed" interest rate swap with a financial institution. Under this arrangement, the municipality will exchange a stream of fixed-rate interest payments for a stream of variable-rate payments. These variable-rate payments from the counterparty will be used to settle the interest obligation of existing municipal bonds. This swap permits the municipality to convert its variable-rate interest liabilities into fixed-rate obligations without restructuring the bonds. In principle, this can ease cash-flow planning and save money if the instrument is used carefully and conservatively. Robbins and Simonsen advise city officials not to use these complex financial instruments unless they fully comprehend the risk involved.

Another way to finance public goods is to invite the private sector to construct and maintain the facilities directly. José A. Gómez-Ibáñez argues that private participation in the provision of road and highway services in the United States has not been very successful. He provides three explanations in chapter 14. First, concessions are hard to obtain in this country. Greenfield concessions to build and operate a new expressway are rare because of the existence of the extensive interstate highway network. Brownfield concessions to maintain and operate an existing road are also uncommon because existing roads were financed by federal motor fuel taxes under the condition that motorists could use them toll-free.

Second, the transaction costs of contracting road services to private entities are so high that they outweigh the benefits of concessions. It takes time and resources to design, award, and monitor a concession contract. The government could rely on a single contract that may help to improve accountability and coordination of separate activities. However, a single big contract also requires more careful design and scrutiny, thereby complicating the negotiation and enforcement of the contract.

Third, concessions have sometimes been employed not to enhance service efficiency but to obtain private capital for easing immediate fiscal deficits. Although Gómez-Ibáñez believes that the intention in these cases was misplaced, the approach was attractive to politicians who wanted to keep the cost of tapping private capital off the books. Gómez-Ibáñez proposes minimizing the transaction costs of concessions by shortening the duration of the agreements from 99 years to 15 or 25 years. In granting concessions to private entities, the government should shift from demanding large up-front payments to some provision for profit sharing. This may create an incentive for concessionaires to improve efficiency and lower tolls.

Viewing private participation in road services from an international perspective, José C. Carbajo believes that the prohibition of tolls should not be an insurmountable problem for brownfield concessions in the United States. "Shadow tolls" or "availability payments" that are currently used in Europe to pay private road companies are possible options. The former are government payments to private companies based on realized traffic, and the latter are for maintaining the motorway to keep it available for use at a specified quality. Carbajo also indicates that some countries have developed a value-for-money method to assess the costs and benefits of private participation in highway services. This method, if incorporated into the screening process, may help to eliminate proposals that have high transaction costs or focus on transfers rather than on efficiency. Carbajo emphasizes that the involvement of the private sector in road developments can also improve the performance of the public sector through the transfer of technology and administrative know-how.

Comparisons of the Property Tax with Other Revenue Instruments

After detailed reviews of different local revenue sources, the chapters and commentaries in this section synthesize and reflect on ideas presented in the previous sections. David L. Sjoquist and Andrew V. Stephenson evaluate the property tax, local sales tax, and local income tax using a standard set of criteria, including efficiency, equity, tax base mobility, ease of administration, fiscal disparities, tax diversification, and other relevant factors. Here we summarize the findings about the measures for which evidence is more conclusive.

In comparing the efficiency of the three local taxes, Sjoquist and Stephenson rely on the concept of benefit tax and the measure of excess burden. They argue that a market-value-based property tax and the local income tax could resemble a benefit tax if collections are spent on services that enhance property value and income. The local sales tax does not seem to have any linkage between its tax base and the usage of revenue. They also review the literature on measuring the deadweight losses of these taxes. Because local income tax rates are generally flat, this tax scores well in terms of generating less economic distortion within the taxing jurisdiction. The property tax could lead to welfare gains only if it taxes land more heavily than buildings. Exemptions and the high rates of local sales taxes do alter resource allocation, thus creating inefficiencies.

In terms of equity, Sjoquist and Stephenson evaluate local taxes based on their ability to tax commuters who benefit from local services that they do not pay for. They assert that the local sales tax is most effective among the three levies in collecting revenue from nonresident shoppers and tourists. The local income tax is less effective than the sales tax because it does not always tax nonresident workers. Among the three taxes, the property tax performs the worst because its tax base is limited to local properties that are mostly owned by residents. However, for central business districts, taxing business property owners who do not reside in the city where they work could be useful.

Sjoquist and Stephenson also find that the local sales tax is much more regressive than the property tax. However, when tax assessments are based on acquisition cost, variations in assessment ratios between new and old properties are huge, creating horizontal inequality. There is no existing study on the distribution of the local income tax burden on different income groups.

Evidence on tax base mobility of the property tax and local sales tax is mixed and varies across cities. Estimated values of the elasticity of the property tax base with respect to the differential tax rate fall between –0.15 and –1. Comparing these estimates with the values of the elasticity of retail sales with respect to the differential sales tax rate that ranges from –0.2 to –4,[1] the local sales tax base appears to be more mobile than the property tax base. No conclusion can be drawn for the local income tax because of insufficient studies.

The total administrative cost of the property tax is higher than that of local sales and income taxes due to the requirement of periodic tax assessments. Its compliance costs are lower than those of the two other taxes because property tax evasion is difficult. If a local sales tax could be piggybacked onto the state sales tax and have the same tax base as the state base, its administration would be greatly simplified. Although the local income tax can also be piggybacked on the state income tax, it is still necessary to identify the jurisdiction in which the

1. Mikesell reports ever higher values of the elasticity that range from –3 to –7.

individual lives and works, thereby making its administration a bit more complicated than the administration of the local sales tax.

In sum, existing studies show that the property tax performs better than local sales and income taxes in efficiency, tax base mobility, and compliance. If its assessed taxable base could be based on market value, the property tax would also score well in fairness. The local sales tax is a useful instrument to avoid free riding by commuters. It can also be administered inexpensively if taxes are collected by the state utilizing the same tax base. Because the local income tax is not widely used, there is not enough evidence to evaluate this instrument.

William F. Fox raises several questions about the comparisons of the three local taxes. First, the administrative and compliance costs of the local sales tax depend on whether the local government could tie its sales tax system to that of the state. Following the same logic, if all states could have similar sales tax structures, this would further lower the administrative costs for the entire state and local government sales tax system. How could this kind of reform be carried out? Second, Fox wonders how the declining popularity of the property tax among voters may affect the choice among the three local taxes. Specifically, acquisition-value assessments have been one of many approaches for softening anti–property tax sentiment. Yet, this method has greatly increased horizontal inequity. How could local governments deal with this trade-off?

While Sjoquist and Stephenson compare local tax and nontax instruments based on an extensive literature review, Tracy M. Gordon and Kim Rueben concentrate on the ideas presented by the chapter authors. They argue that the revenue mix changes all the time in response to economic shocks, policy shifts, and technological advances in tax collection and administration, and that there seems to be a tendency toward the continuation of past practices in local public finance. Thus, if the property tax is a major revenue source for a municipality, local officials may continue with this path. Many state lawmakers have considered relief measures for property tax limits in view of the fiscal needs of local governments. For example, Florida, Georgia, Indiana, and Texas contemplated the possibility of eliminating their property tax limits altogether in 2007. Despite suggestions from many authors that other local taxes should be used, Gordon and Rueben suggest the continuous prevalence of the property tax.

When considering the impacts of alternative revenue sources on local budgets, Gordon and Rueben believe that including public expenditures in the analysis is critical. Although linking revenues to spending is hard to do, voters must realize the implications of their decisions about any tax policy changes. They argue that the key for any revenue system is transparency and accountability. The only way to increase revenues is for municipalities to deliver better outcomes for the taxes levied.

Gordon and Rueben also think that the 2008 financial crisis might have created a favorable time to rethink the current structure of U.S. fiscal federalism. Municipal expenditures that have large spillovers might be reassigned to higher levels of government. The provision of club-goods-like public services should be delegated to the private sector. For local revenues, they argue for state expansion of tax instruments available to localities and a relaxation of federal government rules on intergovernmental transfers.

Gordon and Rueben also observe that data for comprehensive analyses of local fiscal dynamics are limited. For example, systematic information about development impact fees, TIFs, BIDs, and HOAs does not exist, leading to reliance on simulation models and stylized data to examine the fiscal impacts of these instruments.

Expanding on Gordon and Rueben's call for a large-scale restructuring of U.S. fiscal federalism, Michael J. Wasylenko suggests the idea of "flat and value-added tax (VAT)." This means that taxes on income should have broad bases and few deductions to allow buoyancy even with low tax rates. Besides, a federal VAT that can minimize distortions of relative prices among goods, services, leisure, and saving should be established. Wasylenko recognizes that any changes to income taxes are difficult because of tax base competition among different levels of government. If the federal government relies more heavily on income taxes, raising state and local income tax rates on the same base can lead to dangerously high marginal tax rates. Such a proposal will be unlikely to get voters' support. Adopting a federal VAT that has an advantage over the retail sales tax on taxing intermediate goods, services, and interstate commerce seems sensible to Wasylenko. He also suggests extending the use of tax on miles traveled related to car consumption and of the gross receipts tax.

Lessons for Dealing with the Municipal Fiscal Crisis

Based on their evaluation of municipal revenue sources, the contributors to this book propose many interesting ideas for city managers to consider in dealing with their fiscal problems. This section compiles the main points and identifies strategies that municipalities may follow.

First, there is no quick fix. The "perfect storm" in the financial sector took several years to gather its strength before hitting global economies with unprecedented force in 2008. The economic recovery, many economists predict, will be slow. Hence, there is no fast and easy way for municipalities to close fiscal gaps. The worst thing that could happen now is for cities to make shortsighted fiscal choices that compromise the restoration of financial health. The aim of any fiscal reform should be not short-term deficit reduction, but long-term rehabilitation of municipal finances.

Second, solutions must not undermine the city's economic base. The root cause of municipal fiscal crises is the decline in personal and corporate income, retail sales, and property values, all of which comprise the main tax bases for the city. Thus, fiscal remedies need to strengthen the economic foundation of the city and its local tax bases. City officials should consider expanding packages of local services and user fees that can attract productive labor and capital. For instance, impact fees can be an alternative to detailed land use regulations. On one hand, such development fees minimize public subsidies to new development, and on the other hand, they often reduce barriers to property construction that can create jobs and housing units, thereby enlarging the income and property tax bases.

Third, municipalities should continue to strengthen their property tax systems. Property tax collections are more stable than local sales and income taxes. The property tax can be viewed as a benefit tax because public investment in local services and infrastracture can enhance property values. Tax assessments should be based on the current market value of property to promote horizontal equity. City officials may also experiment with a split-rate property tax that taxes land more heavily than buildings (Dye and England 2009). In principle, this tax can improve land use efficiency without causing significant migration of the property tax base. These choices, however, are city-specific because municipal fiscal structures are heterogeneous. New England cities rely heavily on their property tax systems, while municipalities in the North Central, South, and West are more reliant on user fees. Existing legacies should be taken into consideration when contemplating any reforms.

Fourth, tax hikes should always be tied to service improvements. If municipalities have to raise taxes to fund the necessary public goods, city officials must explain to taxpayers how the revenue will be spent. A revenue-expenditure linkage is crucial because it is the only way to persuade taxpayers to provide more municipal revenues during financially challenging times. TIF and community facility districts represent possible models to create this linkage, but the implementation of these systems needs to have broad support. The critical test for their adoption is whether they can enhance service delivery rather than raise immediate cash for the city by issuing off-budget debt.

Fifth, in financing long-term infrastructure investment, making public debt instruments complex and opaque in order to bypass public approval is shortsighted. The lack of transparency will increase citizens' distrust of government, making future public approval of legitimate debt financing of public projects more difficult.

Sixth, cities may encourage businesses to provide neighborhood-level club goods to complement local public services. If a crime watch program in a BID district can enhance the performance of the city's police department, there is no reason to discourage this type of community action. Critics argue that this system could lead to the marginalization of the public sector, rendering services unavailable to poor neighborhoods. To mediate this concern, the municipality can set a minimum standard for all business areas and then allow commercial districts to provide additional private services based on local preferences and ability to pay.

Seventh, and last, solutions for municipal finances entail inter- and intragovernmental collaboration. Municipalities cannot handle their deficits alone because they are created by the states to fulfill their public mandates. Whether municipalities can raise local taxes and user fees or introduce new ones depends on authorization by the state. As cuts in state aid are expected, it seems reasonable for cities to have additional scope to deal with their fiscal shortfalls and to renegotiate reassignment of spending responsibilities with the state. Expansion of local taxes for which municipalities share tax bases with federal and state governments will be contingent on what these higher levels of government will do with the levies. For instance, if a federal VAT is implemented, would local sales taxes in some cities be capped or even abolished? If so, would federal reimbursements for loss of local sales tax revenue be available? Answers to these questions will depend on how municipalities interact with federal and state policy makers during the decision process. Having a strong city government coalition to work with higher-level governments to avoid adverse effects of their fiscal policy changes and unfunded mandates is more important than ever.

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