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FEDERAL, STATE, AND LOCAL FINANCE IN A METROPOLITAN CONTEXT

As a framework for analysis of budget policy—both the revenue and the expenditure sides of the accounts—Musgrave's normative conception is as useful in a metropolitan context as it is in the national context.¹ In the provision and financing of public services in metropolitan areas, how should, and do, the allocation, distribution, and stabilization branches function? Equally important, how do they interact?

Taking them in reverse order, it is apparent that stabilization goals neither should nor can play a *major* role in decisions on urban public services and their financing. They should not, because stabilization objectives should be centrally established and executed within a single national economy. They cannot, because the principal actors, local and state governments, do not possess the money-creating powers ultimately necessary to support functional finance. The subnational governments have such limited flexibility even short of the capacity to borrow without limit, that they can be viewed as more or less passive reactors to, rather than aggressive fighters of, economic fluctuations.²

Indeed, the evidence from the Great Depression, as initially interpreted, suggested that subnational governments are actually "fiscally perverse," in that their reactions tend to reinforce fluctuations.³ That is, they cut back expenditures and increase tax rates in downturns and behave in an opposite fashion in booms, as a consequence of the limitations and pressures they confront. A considerable literature has evolved which questions the validity of the thesis during the Great Depression itself and, more importantly, demonstrates that the thesis has not held in the years since World War II.⁴ The general finding is that

* Professor of Economics, New York University.

¹ Richard A. Musgrave, *The Theory of Public Finance* (McGraw-Hill, 1959), Chap. 1.

² See the list of limitations in Robert W. Rafuse, Jr., "Cyclical Behavior of State-Local Finances," in Richard A. Musgrave (ed.), *Essays in Fiscal Federalism* (Brookings, 1965), pp. 65-66.

³ The principal interpreters were Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (Norton, 1944); and George W. Mitchell, Oscar Litterer, and Evsey D. Domar, "State and Local Finance," in Board of Governors of the Federal Reserve System, *Public Finance and Full Employment* (1945).

⁴ See especially Rafuse, *op. cit.*, and Ansel M. Sharp, "The Behavior of Selected State and Local Government Fiscal Variables During the Phases of the Cycles, 1949-1961," *Proceedings of the National Tax Association*, 1965.

the strong secular rise in the scale of state-local finances has overwhelmed cyclical influences. In fact, because of the peculiar sensitivity of the markets for tax-exempt securities to changing credit conditions, there has been some modest counter-cyclical effect.⁵ The lack of "fiscal perversity" in the past twenty years has been made possible, to some extent at least, by the institution of some of the changes—notably improvements in intergovernmental fiscal relations—suggested by Hansen and Perloff in their original indictment. But the absence of "fiscal perversity" does not demonstrate that pursuit of stabilization objectives is or can be a significant aspect of subnational public sector budget policy.

As for distribution, the logical solution is Musgrave's: in a federal system, conscious redistributive fiscal adjustments should be made at the central government level. As Musgrave says, "Unless this is done, distributional adjustments at the state level may come to be nullified by interstate movement, and serious barriers to an optimal location of economic activity may be imposed."⁶

Logical or not, the subnational public sector does produce substantial redistribution. This is not necessarily conscious policy, but a consequence of expenditure programs designed for much narrower ends—the relief of destitution, the provision of merit goods (education, health services, etc.) to the poor—and of political compromises in state-local tax policy. This redistribution is the net result of a fairly pronounced "pro-poor" pattern of expenditure incidence, combined with a moderately regressive pattern of state-local tax incidence. Most state-local tax incidence studies have resulted in incidence curves of a modified reverse "J" shape: sharp regressivity at the very low incomes, proportionality over a fairly broad middle-income range, and a small degree of progressivity at the upper ends of the scale. This finding, of course, largely reflects the incidence of the property and sales taxes, dominant at the local and state levels, respectively.⁷

⁵ Frank E. Morris, "Impact of Monetary Policy on State and Local Government: An Empirical Study," *Journal of Finance*, Vol. 15 (May 1960).

⁶ Musgrave, *The Theory of Public Finance*, p. 181. Musgrave points out that this solution would be more or less similar to one in which Buchanan's "fiscal residuum" (from operations of all levels of government) is equalized and subnational governments depend upon benefit taxes. See James M. Buchanan, "Federalism and Fiscal Equity," *American Economic Review*, Vol. 40 (September 1950).

⁷ See, for example, O. H. Brownlee, *Estimated Distribution of Minnesota Taxes and Public Expenditure Benefits* (University of Minnesota, 1960); Richard A. Musgrave and Darwin W. Daicoff, "Who Pays the Michigan Taxes?" *Michigan Tax Study Staff Papers* (Michigan Legislative Tax Study Committee, 1958); University of Wisconsin Tax Study Committee, *Wisconsin's State and Local Tax Burden* (1959); Levern F. Graves, "State and Local Tax Burdens in

Those studies which have examined expenditure benefits generally find that average dollar benefits per family rise very slowly indeed as income rises (no matter what the basis of allocation).⁸ The combined result is significant redistribution. For example, the Minnesota study found that expenditure benefits per family were at least twice as great as the tax incidence for families with incomes of less than \$5,000.⁹

TABLE 1.
ESTIMATED INCOME REDISTRIBUTION EFFECTS OF THE PROPERTY TAX
AND THE LOCAL SERVICES IT FINANCES, 1957^a
(millions of dollars)

Money income class	Amount for class	Cumulative
Net additions to income, for class:		
Less than \$2,000	315	315
\$2,000-3,000	180	495
3,000-4,000	190	685
4,000-5,000	485	1,170
5,000-7,000	280	1,450
Net subtractions from income, for class:		
Over \$15,000	740	740
\$10,000-15,000	435	1,175
7,000-10,000	275	1,450

^a Based on data in and underlying Netzer, *Economics of the Property Tax* (Brookings, 1966), Chap. 3, especially Table 3-14. The tax incidence case used is Case II, after federal tax offsets. The benefits incidence case is Case IA. The value of federal tax offsets has been allocated on the basis of the distribution of federal individual income tax payments by adjusted gross income class.

Gillespie's nationwide study found that, as of 1960, the *net* benefits for income classes below \$3,000 exceeded 25 per cent of family money income before taxes.¹⁰ An analysis confined to the property tax and the local expenditures it finances estimates that in 1957, when \$12.3 billion in local property tax revenues financed about half of local

California," California Assembly Interim Committee on Revenue and Taxation, *1964 Report*; University of Maryland, College of Business and Public Administration, *Maryland Tax Study* (1965); Gerhard N. Rostvold, "Distribution of Property, Retail Sales, and Personal Income Tax Burdens in California: An Empirical Analysis of Inequity in Taxation," *National Tax Journal*, Vol. 19 (March 1966); Dick Netzer, *Economics of the Property Tax* (Brookings, 1966), Chap. 3; Alan D. Donheiser, "The Incidence of the New York City Tax System," New York University, Graduate School of Public Administration, *Financing Government in New York City* (1966).

⁸ See, for example, Brownlee, *op. cit.*; Musgrave and Daicoff, *op. cit.*; Netzer, *Economics of the Property Tax*.

⁹ Brownlee, *op. cit.*, p. 2.

¹⁰ W. Irwin Gillespie, "Effect of Public Expenditures on the Distribution of Income," in *Essays in Fiscal Federalism*, pp. 122-86.

FEDERAL, STATE, AND LOCAL FINANCE

general expenditure, the fiscal process produced a net shift of \$1,450 million from income groups above \$7,000 to those below \$7,000 (see Table 1). The very rough characterization of local government finances in metropolitan areas as of 1962, shown in Table 2, similarly suggests important redistribution, and no doubt substantially understates its extent.

TABLE 2.
CRUDE REDISTRIBUTIVE CHARACTERISTICS OF LOCAL GOVERNMENT FINANCE
IN METROPOLITAN AREAS, 1962^a

(billions of dollars)

Probable over-all incidence	General expenditure (net of charges)	Financing, excluding charges
Progressive, on balance ^b	14.0 (56%) ^c	2.2 (9%) ^d
Roughly proportional	11.1 (44%)	9.6 (38%) ^e
Regressive, on balance	—	13.3 (53%) ^f
Total	25.1 (100%)	25.1 (100%)

^a Basic data from U.S. Bureau of the Census, *Census of Governments, 1962*, Vol. V, *Local Government in Metropolitan Areas* (1964), Table 9.

^b "Progressive expenditures" are defined here, for ease of exposition, as those which have the same redistributive effect as progressive taxes.

^c Includes education, welfare, health, and hospital expenditure net of charges.

^d Includes estimated share of intergovernmental aid financed from state and federal income taxes.

^e Includes local revenues (excluding the property tax) and state aid financed from non-income tax funds.

^f Includes the property tax.

Distribution policies or consequences ultimately concern individual consumer units. One dimension, the usual measure in incidence studies, is the proximate dimension of incidence by income *class*. Another dimension, important in a metropolitan context, is that of *geographic* redistribution within large urban areas. The fragmentation of tax bases among a large number of political jurisdictions of extremely disparate character, the highly uneven geographic distribution of expenditure needs (notably, residences of the poor) and the possibility of exporting some tax burdens across jurisdictional lines, together suggest that the metropolitan fisc might have redistributive consequences among communities. The usual variant of this is the "suburban exploitation of the central city" hypothesis, aspects of which are discussed below.¹¹

Whether or not the hypothesis is valid, it does seem likely that analysis of net fiscal incidence on a highly disaggregated geographic basis—by communities within a single urban area—would produce

¹¹ See also Wilbur R. Thompson, *A Preface to Urban Economics* (The Johns Hopkins Press, for Resources for the Future, 1965), Chaps. 3 and 7.

rather different results than the more usual aggregative studies. Aggregation tends to reduce the regressivity of the principal local revenue, the property tax, by combining high-housing-consuming suburbanites with low-housing-consuming city dwellers, the former with high incomes and the latter with lower incomes. Effective property tax rates are usually higher in the larger central cities,¹² but these differences are not reflected in the aggregate studies, which apportion property taxes in some relation to housing consumption. In any case, the evidence suggests that the property tax is far more regressive within individual cities than it is on a statewide or nationwide basis.¹³ It seems likely that, in reality, the fiscal systems of the large metropolitan areas produce almost no redistribution between the central city poor and the suburban rich, aside from that not insignificant element resulting from the operation of state and federal grant programs.

It is evident that the allocation branch dominates the provision and financing of urban public services; that is, the primary purpose of subnational public finance is the support of goods and services which, for one reason or another, will not be provided in "adequate" quantity and quality in the absence of governmental action. In almost any classified tabulation of local government expenditure—that in Table 2, for example, or the Brownlee classification¹⁴—allocation branch items predominate.

The allocation branch comprehends the provision of what Musgrave has called social wants and merit wants, and also the provision of a substantial volume of what are essentially private goods but which, because of historical accident or otherwise, fall in the public sector (e.g., water supply in most parts of the country). The problem in the case of social wants is to discover and satisfy consumer preferences as if market solution were in fact obtainable; in the case of merit wants, the problem is to arrive at some type of political settlement. But in all cases some of the usual private sector standards or requisites for optimization apply here as well: the need for adequate knowledge of alternatives and an institutional setting in which this knowledge can be effectively utilized by the participants in the processes; some degree of mobility of factors among uses and over space; the existence of a continuum of alternatives rather than stark either-or choices; and so on.

¹² See Netzer, *Economics of the Property Tax*, Chap. 5.

¹³ See Donheiser, *op. cit.*

¹⁴ In O. H. Brownlee, "User Prices vs. Taxes," in Universities-National Bureau of Economic Research, *Public Finances: Needs, Sources and Utilization* (Princeton University Press, 1961), p. 424; see also C. Harry Kahn's comments on Brownlee at pp. 436-37.

The majority view is that these requisites do not exist in the real world of public finance in metropolitan areas. In part, this is because of legal restrictions on the powers of local governments to act. But a far more important source of the difficulty is held to be the fragmented nature of local government in metropolitan areas, which limits mobility, impedes free exercise of consumer preference, and magnifies externalities to the point where they often exceed in magnitude internalized costs and benefits.¹⁵ The argument essentially is that existing institutional arrangements do inhibit optimal solutions—that the financing devices themselves, in the context of a fragmented structure of government, add more or less avoidable imperfections to those inherent in the nature of the public sector. We turn now to an examination of this set of issues.

EFFECTS OF FINANCING ARRANGEMENTS ON THE OUTPUT OF SERVICES

Local Tax Sources

As Table 3 indicates, local taxes finance slightly less than half of the cost of public services in metropolitan areas.¹⁶ And when we speak of "local taxes," we mean the property tax and little else, except for the small number of large central cities (like New York, Philadelphia, St. Louis, and a number of Ohio cities) which obtain significant revenues from non-property tax sources. Moreover, at least some of the intrametropolitan consequences of the property tax are common to other locally imposed tax devices.

The usual conclusion is that the fragmented governmental structure with its attendant spillovers of costs and benefits leads to: ". . . an allocation of resources to collective consumption that is below the optimum level that would be indicated if all benefits of such consumption were appropriable in the spending community. . . . The inefficiencies, in terms of under-allocation of resources to the public sector, and the accompanying inequities, go a long way toward providing some

¹⁵ For the best statement of this, see Harvey E. Brazer, "Some Fiscal Implications of Metropolitanism," in Benjamin Chinitz (ed.), *City and Suburb: The Economics of Metropolitan Growth* (Prentice-Hall, 1964). For a dissenting view, see David Davies, "Financing Urban Functions and Services," *Law and Contemporary Problems*, Vol. 30 (Winter 1965).

¹⁶ Table 3 includes, as revenue, direct state government outlays for highways and public assistance and estimated state contributions for employee retirement; this was done to adjust for differences in the distribution of functional responsibilities among the states.

TABLE 3.
SOURCES OF FUNDS FOR PUBLIC SERVICES IN METROPOLITAN AREAS,
PER CENT DISTRIBUTION, 1962^a

Source		Per cent of total
Federal and state governments		32.3
Federal aid	1.7	
State aid	19.4	
Other state government funds ^b	11.2	
Local taxes		45.7
Property	39.3	
Other	6.5	
General sales	2.6	
Income	0.8	
User-charge-type revenues		17.4
Charges and special assessments	9.1	
Utility revenue	8.3	
Other local sources ^c		4.5
	Total ^b	100.0

^a Based on data in U.S. Bureau of the Census, *Census of Governments, 1962*, especially Vol. V.

^b Includes direct state government expenditure for highways and public assistance, and estimated state government contributions to retirement systems for metropolitan area local government employees.

^c Includes employee contributions for retirement, liquor store revenue, sale of property, interest earnings, and other and unallocable.

Note: Because of rounding, detail may not add to totals and subtotals.

understanding, if not explanation, of the major problems confronting metropolitan America."¹⁷

In concept, the coexistence of a large number of small governmental units within a single urban area need not lead to undernourishment of public services or other suboptimal results. Tiebout has provided a model, at a fairly high level of abstraction, in which individuals reveal their preferences for public goods much as they do in the course of voluntary exchange in the private sector.¹⁸ Under a set of restrictive assumptions, he views suburban communities as competing for residents by offering differing packages of public services combined with the tax rates required to finance the services; consumers choose among the communities on the basis of their relative preferences for collectively provided vis-à-vis privately provided goods and services. Obviously, to

¹⁷ Brazer, "Some Fiscal Implications of Metropolitanism," *op. cit.*, pp. 144, 145. See also Lyle C. Fitch, "Metropolitan Fiscal Problems," in Chinitz (ed.), *City and Suburb*, for a good exposition of the undernourishment hypothesis.

¹⁸ Charles M. Tiebout, "A Pure Theory of Local Expenditure," *Journal of Political Economy*, Vol. 64 (October 1956).

the extent that this abstraction is applicable to the world we live in, it offers an attractive means of arriving at an optimal solution to local finance problems, a solution which reflects consumer choice.

Unfortunately, Tiebout's restrictive assumptions usually do not apply: mobility and knowledge is restricted; externalities exist; and actual fiscal flows are complex and often unrelated to decisions of individual consumer-voters. Therefore, it is not surprising that the pattern of tax rates and expenditure levels the Tiebout thesis would lead one to expect—a high and positive correlation—is seldom observed in metropolitan areas.¹⁹ In fact, the most common pattern is the opposite one: tax rates and expenditure levels are *negatively* associated. At least, this has been the finding in most reported studies.²⁰

The explanation for this appears to lie in the enormous disparities in taxable capacity among the political jurisdictions in the larger metropolitan areas. There is a strong positive correlation between tax base and expenditure levels. The richer communities—those with extensive concentrations of business property (or non-property tax bases) and those dominated by high-value residential¹ property—do spend a good deal more than the poorer communities, by and large. But they do not spend as much more as their superior tax bases would permit. Therefore, tax rates and tax base tend to be negatively correlated; the richer communities provide superior services at lower tax rates.

This is a general description of the pattern of variation among jurisdictions outside the central cities. The central city-suburb comparison presents a somewhat different, but analogous, pattern. Generally, central cities spend significantly more, on a per capita basis, than suburban communities which are, on balance, richer. This is mainly (but not entirely) a consequence of the concentration of poverty-linked public service needs and outlays in the central cities. However, the per capita property tax base in most large central cities is well below that of their surrounding areas.

This has not always been the case. At one time, the central cities had a near-monopoly on non-residential property which offset their parallel near-monopoly on low-value housing. But they have lost the

¹⁹ Indeed, the surprising thing is that this pattern is *ever* observed. But it is, for example, in regard to non-school expenditures and taxes in upper-income Chicago suburbs (the presumed laboratory for Tiebout's observations). See Netzer, *Economics of the Property Tax*, pp. 125-31.

²⁰ See, for example, *ibid.*, pp. 125-31; Julius Margolis, "Municipal Fiscal Structure in a Metropolitan Region," *Journal of Political Economy*, Vol. 65 (June 1957); and "The Variation of Property Tax Rates within a Metropolitan Region," *National Tax Journal*, Vol. 9 (December 1956); Donald J. Curran, S.J., "The Metropolitan Problem: Solution from Within?" *National Tax Journal*, Vol. 16 (September 1963).

former near-monopoly, with the dispersal of industry away from central locations, while retaining the latter. The upshot is that effective property tax rates in most large central cities exceed those outside the central cities. In most other places the effective rates are roughly equivalent. This is usually explained by existence of important non-property taxes utilized mainly by central cities. On the whole, therefore, tax levels in central cities are significantly higher than in suburbs (as a group). Moreover, these higher tax levels buy services which are inferior in a number of important respects, notably in regard to schools.²¹

Some observers have argued that there is a pronounced observable trend toward reduction in intrametropolitan fiscal disparities—a trend toward uniformity accompanying increased economic specialization within metropolitan areas.²² To a considerable extent, such observations have been a result of rising expenditures, values, and tax rates on the newly urbanized, formerly rural fringes of metropolitan areas: they have become more like the already developed sections. It is by no means certain that disparities are disappearing within the already urbanized sections of metropolitan areas, and it may be that central city-suburban disparities are *increasing*.

However this may be, the existing disparities afford a rational explanation of the notorious resistance of suburban communities to metropolitan-area-wide solutions to governmental problems, and also an explanation of the observed tendency to control land use for maximum fiscal advantage: the fortunate low-tax, high-expenditure communities seek to preserve their favored positions, a natural response.²³ One result is to insulate part of the metropolitan area's economy from local taxation. The extreme cases are the industrial enclaves with few residents and fewer school children; in effect, industrial property in such enclaves is exempt from school taxation.

These are obvious and special cases of the undernourishment hypothesis. The more general cases fall into two classes. First, given the

²¹ For discussion of city-suburbs disparities, see Netzer, *Economics of the Property Tax*, pp. 117-24; Curran, *op. cit.*; Margolis, *op. cit.*; Brazer, *Some Fiscal Implications*; Advisory Commission on Intergovernmental Relations, *Metropolitan Social and Economic Disparities* (1965); Mordecai S. Feinberg, "The Implications of Core-City Decline for the Fiscal Structure of the Core-City," *National Tax Journal*, Vol. 17 (September 1964).

²² See Jesse Burkhead, "Uniformity in Governmental Expenditures and Resources in a Metropolitan Area," *National Tax Journal*, Vol. 14 (December 1961); Netzer, *Economics of the Property Tax*, pp. 132-35.

²³ On the land use effects, see Dick Netzer, "The Property Tax and Alternatives in Urban Development," *Regional Science Association Papers and Proceedings*, Vol. 9 (1962); and Lynn A. Stiles, "Financing Government in the Suburbs—The Role of the Property Tax," *National Tax Association Proceedings, 1960*.

fragmentation and the disparities, local tax support of redistributive services is likely to be restrained. If the poor are concentrated in already high-tax communities, redistributive services can be more amply supported only by taxing the poor more heavily, a self-defeating proposition; the resources of the rich are not available, since these resources belong to other jurisdictions, those with minor needs for redistributive services. Second, non-redistributive services with heavy benefit spill-overs are likely to be undernourished simply because, as noted earlier, the benefits cannot be appropriated by the communities which individually tax themselves for the service. And although all would benefit from a broader base for financing such services, the well-off communities resist nonetheless, since they cannot be sure that a breach in the existing pattern, for financing services affected with major externalities, will not become a much wider assault on their advantageous positions.

Intrametropolitan fiscal disparities thus have both equity and efficiency consequences. Moreover, the efficiency consequences include effects on the location of activity as well as the effects on the level of output of public services. What has been called "fiscal zoning" presumably has some effect on locational patterns; the direction of the effect must be assumed to be suboptimal, away from the pattern which would prevail in the absence of land use controls. There is also likely to be a more direct cause-and-effect relationship: differentials in tax rates within urban areas no doubt have some bearing on location decisions of firms and individuals, and presumably the results are often suboptimal.

The extent of the actual influence of taxes on location is open to question (see below). However, there is no doubt that *fear* of potentially adverse tax influences is a critical factor in state and local tax policy decision-making. It is almost certain that these competitive fears have restrained the increase in local taxes and thus have had feedback effects on the output of public services; this, of course, is not susceptible to quantification.

Anxiety about the competitive effects of tax differentials has given rise to a fairly extensive literature on the subject.²⁴ Most studies take

²⁴ Examples are Wilbur R. Thompson, "Importance of State and Local Taxes as Business Costs," *National Tax Association Proceedings, 1957*; Reuben A. Zubrow, "Some Difficulties with the Measurement of Comparative Tax Burdens," *National Tax Association Proceedings, 1961*; and the studies cited in John F. Due, "Studies of State-Local Tax Influences on Location of Industry," *National Tax Journal*, Vol. 14 (June 1961); and Netzer, *Economics of the Property Tax*, pp. 109-10. Perhaps the best analytical pieces are Harvey E. Brazer, "The Value of Industrial Property as a Subject of Taxation," *Canadian Public Administra-*

a whole state as the unit of observation. They generally conclude that "relatively high business tax levels do not have the disastrous effects often claimed for them,"²⁵ mostly because state-local taxes are so small an element in business costs, even in business cost differentials at alternative locations. This conclusion must be accepted with some reservations. For one thing, the usual studies are too aggregative to uncover the marginal cases in which tax differentials are in fact the only significant cost differentials. Such marginal cases surely exist, and as local tax levels rise relative to total income and output, these cases will become more frequent.

Moreover, tax differentials may reinforce, rather than offset, other cost differentials. This is the prevailing situation with regard to manufacturing activities and the central cities. The dispersive tendencies are powerful, even without tax differentials which work in the same direction. Finally, there is the distinction between *interregional* and *intra-regional* locational effects. Tax rate differentials may not be important enough to offset the major interregional factor cost differentials but can easily be far more significant within a single metropolitan area where other cost differentials are relatively minor.

And tax levels within metropolitan areas do vary considerably among alternative locations. The Campbell study of the New York area, for example, showed a three-to-one range for a sample of twenty-five manufacturing firms among sixty-four locations in the region, a range which surely must affect locational decisions.²⁶ A more recent study of New York City's finances provides fairly clear evidence that the major business tax differentials which have existed in the area actually have stimulated decentralization of economic activity away from New York City.²⁷ Indeed, the evidence is so clear that it has had a major effect on recent tax policy decisions in both New York City and its periphery.

Local business tax differentials will affect locational decisions only to the extent that the tax differentials are in excess of the location rents for a given activity at a particular site and of the value of public services provided to firms in return for the tax payment.²⁸ Ordinarily, the user-charge component of local tax payments is small indeed for business

tion, Vol. 55 (June 1961); and Wolfgang F. Stolper, "Economic Development, Taxation, and Industrial Location in Michigan," in *Michigan Tax Study Staff Papers* (1958).

²⁵ Due, *op. cit.*, p. 171.

²⁶ Alan K. Campbell, "Taxes and Industrial Location in the New York Metropolitan Region," *National Tax Journal*, Vol. 11 (September 1958).

²⁷ See the papers by Leslie E. Carbert, James A. Papke, William Hamovitch, and Henry M. Levin, in *Financing Government in New York City*.

²⁸ See the exposition in Brazer, *The Value of Industrial Property*.

firms. It is by no means small for individuals, especially in dormitory suburbs, which perhaps partly explains the apparent insensitivity of residential location decisions to local tax rate differentials.²⁹ There have been few studies of this, but one survey of high-income individuals suggests almost complete insensitivity.³⁰

However, because the tax-service nexus is far from clear to individuals within central cities, it is reasonable to suppose that high property taxes on housing in the cities are a serious deterrent to central city housing consumption. The consumer perceives only the annual or monthly cost of housing, 25 per cent or more of which reflects property tax payments in most large central cities; he sees little connection between this cost and the quality of public services offered. He therefore is presumably less willing to pay a high price for the housing-cum-taxes package than in a suburban location, where the connection with public services is far more obvious. To the extent that this is true and that its truth is appreciated, however incoherently, by public officials it may explain, indeed justify, the common big-city policy of taxing housing much more favorably than other types of real property.³¹ But this, too, is a circular process, with feedbacks on the output of public services: keeping tax rates low on a large fraction of the tax base restrains the ability of central cities to increase the output of public services.

In summary, then, the prevailing metropolitan area local tax structure—heavy reliance on the property tax by a large number of taxing jurisdictions—appears to restrict the output of public services to a level below that which might obtain under other institutional arrangements. The existing structure also has suboptimal effects on location decisions and land use patterns, and these effects in turn probably further restrict the output of public services. What other institutional arrangements (confining the discussion here to locally imposed taxes) might there be?

For the central cities, at least, a partial solution is to be found in non-property taxes, on personal income and/or consumption (non-

²⁹ Another explanation may be found in the federal individual income tax offsets to local taxes. See Benjamin Bridges, "Deductibility of State and Local Nonbusiness Taxes under the Federal Individual Income Tax," *National Tax Journal*, Vol. 19 (March 1966); "Allowances for State and Local Nonbusiness Taxes," in Musgrave (ed.), *Essays in Fiscal Federalism*.

³⁰ James N. Morgan, Robin Barlow, and Harvey E. Brazer, "A Survey of Investment Management and Working Behavior Among High-Income Individuals," *American Economic Review*, Vol. 55 (May 1965), p. 259; this is more fully developed by the same authors in *Economic Behavior of the Affluent* (Brookings, 1966), pp. 169-70.

³¹ For an extended discussion of this, see my *Economics of the Property Tax*, pp. 74-85, and *Financing Government in New York City*, pp. 58-61, 710-15.

property business taxes levied by local governments have no obvious advantages, on any score, over business property taxes). Personal taxes of a general nature avoid the serious deterrence to increased housing consumption (which is a goal most large older cities actively pursue with a variety of policy devices) inherent in the property tax. They also afford a means of moderately extending the geographic scope of central city taxing powers, by a form of reverse-suburban-exploitation, that is, taxing those suburbanites who happen to work or shop in the central city to defray part of the "excess burden" of redistributive central city services. But presumably the scope for central city non-property taxation is limited by the locational impact; very large differentials will not work.³² Perhaps the greatest potential is in central city personal income taxation, partly because so few state governments rely heavily on income taxation.³³ In any event, those large cities which impose some type of income tax do appear able to reduce their reliance on the property tax by more than do the sales tax cities in places like Illinois and California.

De-emphasis of the property tax would tend to reduce the land use and location effects of local tax structures. The process could also be helped by radical reform of the property tax, into a tax based largely on land values (or land value increments). The potential of land value taxation has recently gained new and well-deserved attention.³⁴

But the essential need appears to be some mechanism for levying local taxes on a broader geographic base, that is, converting some portion of local taxation into area-wide taxes. The objective here would be to provide for more satisfactory financing of both redistributive services and non-redistributive services affected with major externalities. A corollary advantage of area-wide taxation is that the metropolitan area affords a more satisfactory basis for application of the superior forms of taxation—on income and consumption rather than property—than does a large collection of separate small taxing units. But one cannot be sanguine about the possibilities here. Indeed, one can argue that resort to increased grants from the state and federal governments

³² It is estimated that, when New York City's sales tax rate was 4 per cent and there was no sales tax in surrounding areas, the tax differential reduced retail sales in New York City—of the types sensitive to and covered by the tax—by close to 25 per cent. See the papers by Hamovitch and Levin in *Financing Government in New York City*.

³³ See Advisory Commission on Intergovernmental Relations, *Federal-State Coordination of Personal Income Taxes* (1965), p. 11.

³⁴ See Netzer, *Economics of the Property Tax*, Chap. 8; Clyde E. Browning, "Land Value Taxation: Promises and Problems," *Journal of the American Institute of Planners*, Vol. 29 (November 1963); James Heilbrun, *Real Estate Taxes and Urban Housing* (Columbia, 1966).

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has been, and will continue to be, the most likely and popular means of spreading the tax burden geographically.

Federal and State Financing

As Tables 3 and 4 indicate, federal and state funds finance some-

TABLE 4.
FINANCING OF PUBLIC SERVICES IN METROPOLITAN AREAS,
BY MAJOR FUNCTION, 1962^a

Function	Expenditures (\$ billion) ^b	Sources of funds (per cent distribution)		
		Federal and state governments ^c	User-charge- type revenues ^d	Other local sources ^e
Education	12.4	33	6	61
Highways	4.9	68	5	27
Welfare	2.8	75	—	25
Health and hospitals	1.6	10	25	65
Housing and renewal	1.1	26	30	44
Local utilities	3.2	—	89	11
Other and unallocable ^f	10.1	10	14	76
Total ^g	36.1	31	16	53

^a Based on data in U.S. Bureau of the Census, *Census of Governments, 1962*, especially Vol. V.

^b Includes direct state government expenditures for highways and public assistance, estimated state government expenditure for retirement systems for metropolitan area local government employees, and estimated local government contributions to their own retirement systems. Interest allocated crudely by function and, where possible, retirement system amounts also allocated.

^c Includes, in addition to aids, the state government expenditure described in the preceding note. Functional distribution estimated.

^d Functional distribution partly estimated.

^e Computed as residual; includes taxes, miscellaneous revenues, employee contributions to retirement systems, liquor store revenues, borrowing and net use of cash balances. Net borrowing amounted to \$2.8 billion in 1962, about one-seventh of the total in this column.

^f Includes employee retirement system amounts not allocated by function and liquor store finances, as well as other and unallocable general expenditure and its financing.

^g The percentages differ slightly from those in Table 3; that table compares revenue amounts to total *revenues*, while in this table the revenue amounts are compared to total *expenditure*.

what more than 30 per cent of the cost of the public services provided in metropolitan areas. This is on the basis of a broad definition of federal and state financing, to comprehend identifiable direct state government provision of public services in metropolitan areas, as well as the intergovernmental payments through which the external governments help support locally provided services. The most important of

such identifiable direct state services are highways and public assistance.

The states differ considerably in their distributions of responsibilities among the state government and the local units.³⁵ On the average, state governments directly account for about one-third of combined state-local expenditure, but state participation is substantially lower in states like New York, New Jersey, and California and substantially higher in places like Pennsylvania and Connecticut, among the more urbanized states. Greater state aid may or may not offset lower direct state participation, but both factors must be considered in appraising the state role. In some states, like New York, the major intergovernmental problem is in fact the distribution of functional responsibilities, and not state aid formulas and the like.³⁶

Federal and state funds, using this broader definition, finance one-third of local education costs (and, of course, nearly all the *public* costs of higher education), over two-thirds of highway and welfare costs, and much smaller, almost nominal, proportions of the costs of other public services in metropolitan areas. It is clear that local revenue sources bear a substantial residual burden in connection with redistributive services (about \$2 billion for health and welfare purposes, as of 1962) and that external financing is not of major consequence in connection with other services with major spillovers.

These are 1962 proportions, and the percentages have risen somewhat since then. However, the role of external financing has changed relatively little during the past fifteen years; the really revolutionary expansion of the roles of the state and federal government occurred in the 1930's. This is evident from the following tabulation of the percentages of combined state-local expenditures met from state and federal sources:³⁷

	<i>Per cent</i>
1964-65	54
1960	53
1955	51
1950	54
1940	49
1927	26
1902	18

³⁵ See the paper by Morris Beck in *Financing Government in New York City*. Mushkin points out that differences in the assignment of the welfare function are the most important consideration. See Selma J. Mushkin, "Intergovernmental Aspects of Local Expenditure Decisions," in Howard G. Schaller (ed.), *Public Expenditure Decisions in the Urban Community* (Resources for the Future, 1963).

³⁶ *Financing Government in New York City*, pp. 29-31, 36-40.

³⁷ Calculated from U.S. Bureau of the Census, *Census of Governments, 1962*, and *Governmental Finances in 1964-65* (1966).

Financing from taxes levied by higher levels of government tends to overcome spillover problems, disparities in local tax bases and disparities in the concentration of the poor within metropolitan areas; it can also result in greater reliance on taxes with more appropriate distributive effects than usually result from metropolitan area local tax structures. It *can* do these things, although these are not necessarily the explicit reasons for intervention by higher levels of government. More commonly, the motivation for federal action is to encourage the provision of *additional* public services; equalization features are designed to effect this expansion with minimum burdens on taxpayers in the poorer states. In contrast, state government action is usually often justified as a *substitute* for local tax support of a given level of services (notably in connection with state school aid), although some programs give priority to stimulation of local action.

The goals are perhaps of less significance than the effects. Most studies indicate that external grants have strongly stimulative effects. For example, Sacks and Harris found that both federal and state aids in 1960 had strong positive effects on the level of state-local expenditure by state; they also found state aid to be a major stimulative force among local governments within New York State.³⁸ In fact, in New York State, an additional dollar of state aid for schools appears to result in a net increase of 90 cents in school expenditures.³⁹

Bishop, in a study of the New England states as of 1961-62, came up with rather different findings. His conclusions were that state school aids are stimulative, but the stimulative effects were found mainly in the smaller towns. In the larger places, and therefore in the states as a whole on a weighted basis, the primary effect of additional school aid is to reduce local property taxes.⁴⁰ This is consistent with other aggregative studies of school aids, but conflicts with the results of smaller-scale comparisons where similar socioeconomic areas are involved. Take, for example, Bergen County, New Jersey, and Westchester County, New York; both are New York suburbs, with similar high income levels and roughly the same population and public school enrollments, and both have large numbers of separate school systems (seventy-four and fifty, respectively). As of 1962, per pupil expenditures in Westchester

³⁸ Seymour Sacks and Robert Harris, "The Determinants of State and Local Expenditures and Intergovernmental Flows of Funds," *National Tax Journal*, Vol. 17 (March 1964); Sacks, Harris, and John J. Carroll, *The State and Local Government: The Role of State Aid* (New York State Department of Audit and Control, 1963), pp. 120-41.

³⁹ *Ibid.*, pp. 173-75.

⁴⁰ George A. Bishop, "Stimulative versus Substitutive Effects of State School Aid in New England," *National Tax Journal*, Vol. 17 (June 1964).

were about 40 per cent higher than in Bergen, but the bulk of the difference was accounted for by differences in state aid per pupil.⁴¹ This was also true of non-school local expenditure in the two counties. The case that state aid is primarily substitutive would require that local support of local services be lower in Westchester than in Bergen, since state aid is higher and most other variables are similar, but this is not the case.

The structure, as well as the purposes, of state aid programs does permit them to be substitutive. This is not usually the case with regard to federal aid, because of the nature of matching requirements. This, however, does not apply to federal direct expenditure—notably social insurance—which can replace state-local expenditure. It also does not apply to many newer federal grant programs with minor or non-existent matching requirements. For example, the Medicaid provisions of the 1965 federal legislation are expected to *replace* \$110 million annually of locally financed expenditure for hospitals in New York City.⁴²

The effects of grants-in-aid on the output of public services are thus by no means clear; if the primary purpose of grants is to increase public expenditure, they may, in some circumstances be relatively inefficient means of doing so. However, one approach holds that grants are substantially more efficient in increasing public expenditure than is direct state performance of functions. Campbell and Sacks, in a series of papers, have pointed out that the actual structure of intergovernmental relations, which differs widely among the states, is a major determinant of the output of services in metropolitan areas. They include among the structural variables state versus local direct responsibility, the extent of state aid for local functions, and the nature of the subsystems of local government (with complicated overlapping and differentiation in some northern and western metropolitan areas and great simplicity in most southern areas).⁴³ Their findings suggest that the output of public services is relatively high where major local responsibility is combined with substantial state aid and relatively low where the substitute is a larger direct state government role.

The evidence on a statewide basis for the fifteen states with the largest metropolitan area populations (in Table 5) tends to support this

⁴¹ Based on *Census of Governments, 1962*, data.

⁴² See the paper by Katherine W. Strauss in *Financing Government in New York City*, especially pp. 368-70.

⁴³ See Alan K. Campbell and Seymour Sacks, "Administering the Spread City," *Public Administration Review*, Vol. 24 (September 1964); Sacks and Campbell, "The Fiscal Zoning Game," *Municipal Finance*, Vol. 36 (May 1964); Sacks, "Metropolitan Area Finances," *Proceedings of the National Tax Association, 1963*.

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thesis, although not unreservedly so. Three of the four high expenditure states in the top section of Table 5 have below-average state direct roles

TABLE 5.
PER CAPITA EXPENDITURE AND STATE FINANCING,
SELECTED STATES, 1964-65^a

State	Per capita state-local general expenditure	Per cent of state-local general expenditure		
		State gov't. direct expenditure	State aid to local gov'ts.	Total, state-financed expenditure
California	\$203	27%	25%	52%
Michigan	178	32	21	53
Indiana	176	36	20	56
New York	165	22	24	46
Texas	146	34	15	49
Maryland	146	33	25	58
Connecticut	140	43	9	52
Illinois	138	36	13	49
New Jersey	136	24	10	34
Florida	128	36	16	52
Pennsylvania	126	39	16	55
Ohio	126	28	17	45
Virginia	126	42	16	58
Massachusetts	122	32	19	51
Missouri	121	41	12	53

^a Includes fifteen states with largest SMSA population, 1960 (77% of U.S. total). Based on U.S. Bureau of the Census, *Governmental Finances in 1964-65*.

and all have well above-average state grants. Four of the six low expenditure states have relatively high state direct roles; all have relatively low state aids. But there are exceptions in all the groups. Moreover, the correlation between expenditure levels and the combined extent of state government financing is decidedly poor.

However, it is easy to see why the thesis might be applicable conceptually, and perhaps also to explain some of the observed deviations. Consider only expenditures with a primarily allocation branch character. Such outlays are likely to be a good deal higher under a local-performance-with-high-state-aid regime than with high direct state performance. This surely would be the case if the marginal propensity to consume allocation branch services is higher in richer communities. In such a case, high-income communities would devote larger portions of their residents' incomes to public services. Equalizing state aids would tend to increase

the outlays of the poorer communities, with the strength of this tendency dependent on the form of the state aid.⁴⁴ In contrast, state performance would result in an expenditure level suggested by the marginal propensity for public services at the state-wide average personal income level; the result should be somewhat lower public expenditure.

The case is strengthened by the fact that local taxes are deductible for federal income tax purposes. Suppose, for example, that the rate of substitution of public for private goods (that is, the willingness to surrender income for public uses) is invariant with respect to income. The residents of higher-income communities, because of the federal tax offset, would be able to spend more relative to income for local public services without any greater sacrifice of net (after-tax) income. Consider two communities, one in which the residents' average marginal income tax rate is 30 per cent and another in which the rate is 15 per cent. The after-tax cost of a dollar of local public expenditure to the average resident is more than 20 per cent greater in the low-income community. Or, if the willingness to surrender private income is similar in the two places, local expenditures relative to income will be more than 20 per cent higher in the richer community.

But there is no reason to expect this arrangement to work for redistributive expenditures. Indeed, their very concentration in the poorer communities will frustrate any willingness of residents of richer communities to tax themselves to support such services. And, as we have seen, the most important factor making for differences in the direct state role is connected with the locus of the responsibility for that major redistributive service, public assistance. This could explain some of the deviations from the "expected," such as low expenditures in Massachusetts.

At any rate, in concept it does appear that the output of public services might be maximized under a regime in which there is:

- 1) a high degree of local responsibility for allocation branch services;

⁴⁴The issue here is the relative importance of income as against substitution effects. A general-purpose equalizing grant's effects would be virtually all income effects and would produce a proportionate rise in expenditures, on the assumption that the marginal propensity to consume public services rises with community income. A functional grant would have some substitution effects, depending upon matching requirements and the institutional obstacles to substitution. For example, school grants to independent school districts probably produce less substitution of school for other public expenditures than do school grants to general-purpose local governments.

- 2) significant equalizing state aid to the poorer communities for such services; and
- 3) major state (and/or federal) responsibility for redistributive services.

User Charges

As Tables 3 and 4 show, user-charge-type devices finance about one-sixth of public services in metropolitan areas; if state and federal highway-user taxes are classified as user charges, the proportion rises to one-fourth. Relatively heavy reliance on price-like devices to finance urban services seems appropriate. True, user charges are highly inappropriate for redistributive services but, as we have seen, the allocation branch appears dominant in metropolitan finance.

Moreover, within the metropolitan area allocation branch, a significant portion of the output of public services consists of services of an essentially private character, for which the exclusion principle applies: the consumer can be, or actually is, excluded from enjoyment of the service unless he is willing to pay its price.⁴⁵ Some of these are affected with no greater externalities than are most privately produced goods and services (water supply, most transportation services, many recreational activities). In such cases, individuals can vary their consumption (within limits) on the basis of price without efficiency losses, indeed with significant efficiency gains. For other services, where major external *diseconomies* are involved (e.g., air and water pollution, traffic congestion), there is an argument for user charges as "social economy" reimbursements or to induce consumers to eliminate the diseconomies their actions produce.

Intuitively, it seems obvious that financing from user charges, rather than from general taxes, should affect the level of output of public services. If the general thesis, that existing institutional arrangements produce undernourishment of urban public services, applies to services that are amenable to user charges but are not presently financed by them, the effect should be a substantial increase in the output of such services. One reason for this is that user charges can overcome the political fragmentation problem. The charge, presumably, is based on actual use of services or facilities, not the domicile of the taxpayer; the demand of "foreign" as well as "domestic" users can be satisfied, on a compensatory basis, by the managers of the enterprise.

There has been surprisingly little systematic empirical investigation of the effect of user charge financing on the output of services. Casual empiricism suggests that there are in fact higher standards of service

⁴⁵ See Musgrave, *The Theory of Public Finance*, p. 9.

where user charge financing is employed. For example, the essence of the frequent criticisms of the operations of public authorities is that they produce their own "private opulence amidst public squalor." That is, they utilize their command over user charges to produce unusually high-grade services within their spheres of operation.⁴⁶

Rigorous analysis has been applied to one aspect of this question—the effects of earmarking taxes for specific purposes. Buchanan has developed a model, based on individual fiscal choice, which suggests that earmarking will lead to an efficient solution in which expenditures are higher than would otherwise be the case.⁴⁷ An empirical effort to test the Buchanan hypothesis produced negative results—the extent of or change in earmarking seemed to have little effect on expenditure levels.⁴⁸ In an earlier paper, Margolis found that earmarking, in the form of school districts independent of general government, tended to reduce school expenditure.⁴⁹ He explained this on the basis of a log-rolling theory of voting behavior—the multipurpose expenditure package combines the consumer's surplus for specific projects so that voters accept the entire package rather than lose the specific project. His discussants, however, suggested that "backward log-rolling" is possible as well and that the empirical evidence is far from conclusive.⁵⁰ The case, then, must be regarded as not proved, although the Buchanan model is most attractive.

The potential for user charges in metropolitan finance can perhaps be illuminated by a brief review of the extent of user charge financing in metropolitan areas currently, that is, as of the 1962 Census of Governments. As we would expect, charges are of minor significance for services with a major redistributive aspect. *Education* charges amount to about 7 per cent of current operating expenditure, and these are largely school lunch fees, which are far below the full costs of the resources devoted to the program; the subsidy here, of course, is a federal one. *Hospital* charges equal about 35 per cent of current expenditure. The bulk of the revenue is collected outside the largest cities and largest metropolitan areas, where the hospitals serve the general

⁴⁶ For a more sophisticated view of authorities, see Robert C. Wood, *1400 Governments* (Harvard University Press, 1961), Chap. 4.

⁴⁷ James M. Buchanan, "The Economics of Earmarked Taxes," *Journal of Political Economy*, Vol. 71 (October 1963).

⁴⁸ Elizabeth Deran, "Earmarking and Expenditures: A Survey and A New Test," *National Tax Journal*, Vol. 18 (December 1965).

⁴⁹ Julius Margolis, "Metropolitan Finance Problems: Territories, Functions and Growth," in *Universities—National Bureau of Economic Research, Public Finances: Needs, Sources and Utilization* (Princeton University Press, 1961).

⁵⁰ Lyle C. Fitch, pp. 272–73, and William F. Hellmuth, pp. 276–80, in *Public Finances . . . Utilization*.

population and not just the indigent as in the bigger cities. Small-city public hospitals in effect are substitutes for the big-city voluntary hospital. *Public housing* charges (rents) amount to about 90 per cent of current expenditure and in-lieu-of-tax payments; the redistribution occurs here because the federal (and any other public) subsidy is designed to cover all, or nearly all, of the capital costs of public housing.

Turning to allocation branch expenditures, *sewerage* charges are about equal to current expenditure, in the aggregate. But annual economic costs for this heavily capital intensive service are far above current expenditure. Special assessments probably cover about one-fifth of capital outlays. In regard to other *sanitation* services (mainly refuse removal), charges are only about 15 per cent of expenditure. Charges are more commonly utilized in smaller cities and suburbs than in the big cities. Local *parks and recreation*, probably the most rapidly growing urban expenditure, generate charges equal to about 20 per cent of current expenditure. *Fire protection* can be viewed as very much a private good,⁵¹ one which could readily be provided by a privately owned public utility company, but charges are negligible and the service is financed from general taxes.

Transportation services, other than streets and highways, are largely financed from charges. Charges for airports and water terminals substantially exceed current expenditure and probably largely cover debt service costs as well. Public transit systems come close to breaking even in regard to current expenditure; the very large deficits on capital account are concentrated in a very few places, notably New York. Local government parking operations generate large surpluses, in the form of net parking meter revenues, only a small part of which is used to subsidize off-street parking.

Highways are a rather different matter. In 1962, highway expenditure in metropolitan areas totalled \$4.9 billion, of which \$3.3 billion was financed from federal and state funds. The bulk of these funds were derived from earmarked highway-user taxes, which can be considered as user charges in a very aggregative sense. Users provide the funds, and no doubt at a more ample level than might be the case without earmarking, but there is little connection between user tax payments and specific uses of the roads. Of the locally financed \$1.6 billion, about 20 per cent came from user sources, equally divided among local highway-user taxes (mostly licenses and often not earmarked), special assessments for street improvements, and more specific types of charges (mostly tolls). These figures relate to a fairly narrow definition of high-

⁵¹ Ignoring the tiny fraction of fire losses due to fires originating on adjacent properties.

way expenditure. Associated street functions and police traffic control activities probably involve at least \$400 million more in expenditure, and generate only minor user charges.

This review suggests significant potential for greater and more sophisticated application of user-charge-type financing. One of the most serious obstacles to effective utilization of pricing devices in financing public services can be traced to the traditional justification for user charges (and analogous taxes) on the basis of benefits received. The benefit principle, however, is concerned with equity, not allocation: how can we equitably spread the costs of public goods among individuals? But this principle is inappropriate for allocation branch decisions on the financing and provision of services with a substantial private character. Efficiency in allocation requires that prices (or other types of charges) and the level of services provided be determined on the basis of the marginal *costs* of the services. More often than not, there is little correspondence between benefit-determined charges and cost-determined charges.

Vickrey had done extensive work on this. In a major paper, he contrasts benefit and cost solutions for a number of urban services, and advances imaginative (and reasonably workable) cost-based charging schemes.⁵² A number of these schemes involve charges based on site characteristics, such as land area and frontage; in effect, these are offered as substitutes for the existing benefit-justified taxation of the value of land and improvements, that is, the property tax. The pricing of urban transportation services, on a cost basis, has received more attention than anything else, by Vickrey and by others, especially in Britain.⁵³ Fairly elaborate and detailed pricing schemes have been advanced, schemes which radically depart from the conventional benefit approach to highway financing.⁵⁴ Such proposals have met with a rather negative response in this country, but seem to be on the verge of acceptance in conservative Britain.

A MODEL MULTILEVEL SYSTEM

There is no shortage of proposed solutions to the problems posed by

⁵² William Vickrey, "General and Specific Financing of Urban Services," in Schaller (ed.), *Public Expenditure Decisions in the Urban Community*.

⁵³ See, for example, William S. Vickrey, *The Revision of the Rapid Transit Fare Structure of the City of New York*, Finance Project, Mayor's Committee on Management Survey of the City of New York (1952); Lyle C. Fitch and associates, *Urban Transportation and Public Policy* (Chandler, 1964), Chap. 4; U.K. Ministry of Transport, *Road Pricing: The Economic and Technical Possibilities* (1964).

⁵⁴ For a good exposition of this approach, see A. D. Le Baron, "The 'Theory' of Highway Finance: Roots, Aims, and Accomplishments," *National Tax Journal*, Vol. 16 (1963).

the existence of multiple levels of government functioning within urban areas. Solutions include models at high levels of abstraction,⁵⁵ comprehensive sets of policy recommendations,⁵⁶ and more or less pragmatic "practical" solutions.⁵⁷ Most frequently, the theoretical models are efficiency solutions based on individual choice (such as the Musgrave and Tiebout models); they stress spillovers as the basis for allocation branch intergovernmental transfers and relegate redistributive activities to higher level governments. An alternative formulation explicitly allows for differences in consumer preferences as to the "mix of governments" in the provision of services and for changes in this mix as part of the process of adjustment to achieve desired levels of public services.⁵⁸ This formulation minimizes the role of spillovers and rejects distinct roles for the various levels of government. It provides the rationale for a "marble cake," rather than a "layer cake," approach to intergovernmental relations, in which federal, state and local governments all perform some services and do some financing of all the major functions, in differing degrees at differing times and places.

No doubt this is an increasingly accurate description of the observed system. However, it affords no normative standards for appraising the system. Any aspect of intergovernmental action can be considered to be efficient, according to this model, in the sense of reflecting changing consumer preferences for the "mix of governments." Moreover, as a positive theory, it provides little basis for estimating the extent or even the direction of expected change.

There are, I believe, real differences in the capabilities of the levels of governments—in their capacity to realize efficient solutions on the basis of more conventional definitions of efficiency—which are closely related to the vast differences in the geographic coverage of the levels. The federal government, after all, does operate throughout a single integrated economy and, moreover, an economy with only minor external flows. Most of the states are in effect regional governments and

⁵⁵ For example, Charles M. Tiebout, "An Economic Theory of Fiscal Decentralization," in *Public Finances . . . Utilization*; Charles M. Tiebout and David B. Houston, "Metropolitan Finance Reconsidered: Budget Functions and Multi-Level Governments," *Review of Economics and Statistics*, Vol. 44 (November 1962); and Richard A. Musgrave, "Approaches to a Fiscal Theory of Political Federalism," in *Public Finances . . . Utilization*.

⁵⁶ For example, Simeon E. Leland, "An Ideal Theoretical Plan of Finance for a Metropolitan Area," in *Financing Metropolitan Government* (Tax Institute Symposium, 1955).

⁵⁷ For example, L. L. Ecker-Racz and I. M. Labovitz, "Practical Solutions to Financial Problems Created by the Multilevel Political Structure," in *Public Finances . . . Utilization*.

⁵⁸ This is put best in Selma J. Mushkin and Robert F. Adams, "Emerging Patterns of Federalism," *National Tax Journal*, Vol. 19 (September 1966).

comprehend the totality of one or several metropolitan areas.⁵⁹ The states therefore can act with only occasional effects on *intra*regional competition. In contrast, a very large part of the total metropolitan area population spills over the boundaries of even the largest of local government units (usually, the county).

Therefore, it seems appropriate to utilize a formulation based upon some kind of systematic differentiation in the roles of the levels of government. The by now conventional models do just this, by confining the lower levels to allocation branch activities, with intergovernmental adjustments for spillovers. The model suggested here follows this prescription.

In this model, stabilization and distribution activities and goals are basically federal government responsibilities. In reality, the system does function this way to a considerable extent: direct federal action for stabilization objectives; federal social insurance for stabilization and distribution objectives; and federal grants, the bulk of which (excluding the highway aids) are basically redistributive in purpose and effect. The extent to which this is the case is perhaps best illustrated by contrasting current experience with the federal role thirty-five years ago, when stabilization goals were only partly accepted and ineptly acted upon and when redistribution was hardly an important goal of federal action.⁶⁰

Nonetheless, there is, as we have seen, a substantial redistributive element in the finances of state and local governments, notably in connection with education and with non-federal financing of welfare, health, and other poverty-linked services. Nationwide, the obviously poverty-linked services, exclusive of aids and charges, absorb about 10 per cent of local government taxes; in the large central cities, the figure is closer to 20 per cent. In the model system, this is highly inappropriate: individual local governments would have no financial responsibility for clearly redistributive services.

At present, the state government role in the redistributive services is a large one, via grants and direct performance. Health and welfare

⁵⁹ Only 32 of the 219 metropolitan areas are interstate areas. Twenty-three of the 32 have 70 per cent or more of the area's population within the primary state; these 23 include 18 of the 21 areas with 250,000 or more inhabitants. The interstate problem concerns mainly a few large areas. The 6 largest interstate areas—New York SCA, Chicago SCA, Washington, D.C., Philadelphia, St. Louis, and Kansas City—in 1960 had about 7.4 million of their 31.1 million populations in the secondary states. All 213 other areas had only 1.8 million people in the secondary states, about 2 per cent of the total population of these areas. U.S. Bureau of the Budget, *Standard Metropolitan Statistical Areas* (1964).

⁶⁰ George W. Mitchell, "The Federal Impact on Metropolitan Finance," in *Financing Metropolitan Government* (Tax Institute Symposium, 1955).

services financed from state taxes amount to about one-sixth of state tax collections. In the model system, federal grants, social insurance and perhaps a negative income tax would supplant state-financed redistribution. But this departure from the ideal is considerably less obnoxious than is redistribution by separate local units from their own resources. In fact, a shift from local to state support, from intraregional to regional finance, of redistributive services would be a major step in the right direction.

This applies, as well, to metropolitan-area-wide financing devices for distributive purposes. In the single-county metropolitan areas the county government can and often does perform this role. In the larger areas there is no such machinery, and the state government can be viewed as a rough substitute for metropolitan-area-wide government. However, in a number of places there is considerable interest in area-wide taxing arrangements. For obvious reasons, the services directly linked to poverty are unlikely candidates for such support. A much more likely candidate is education; but this has an important redistributive character, too.

The model system would provide for area-wide performance and/or financing in another type of situation: where there are major, obvious spillovers among the political jurisdictions within a metropolitan area. The definition here is essentially a technological one, but with a hazy dividing line between spillover services and services whose costs and benefits are largely internal to individual communities. The externalities with regard to education are large ones, but the external effects are as often extraregional as they are captured within a single metropolitan region. This argues for state and national financing, not only for area-wide arrangements. However, for transportation and air and water pollution control, for example, the very large external effects are primarily confined to a single urban area.

Aside from such types of services, there is little argument for area-wide machinery or performance. Indeed, there is a case for having a multiplicity of small jurisdictions to provide and finance allocation branch activities without important externalities. If the jurisdictions had some correspondence to "natural" service areas for the provision of most local services and if the financing devices were specific cost-based charges along the lines suggested by Vickrey, most of the advantages of the Tiebout solution⁶¹ could be realized. That is, the provision of services would be related to revealed consumer preferences.

Carried to its logical extreme, this arrangement would suggest sepa-

⁶¹ In "A Pure Theory of Local Expenditure," *op. cit.*

rate special-purpose units of government for a long list of services, with different boundary lines for each set of units. This would entail a huge amount of consumer voting and other decision-making. Decision-making is not costless, which points to the desirability of a more limited number of jurisdictions, but not so limited as to rule out effective consumer choice. The losses in consumer choice through fewer units can be offset by greater reliance upon true pricing arrangements, under which consumers have a genuine choice as to the amount of the service they consume.⁶²

This, in outline, is the model system. The real-world departures from it are clear enough: major redistributive elements in purely local finance; absence of area-wide machinery for services with major externalities; a pattern of fragmented local units which is generally poorly designed even to deal with appropriately local responsibilities on the basis of consumer choice. How then can we move toward a better system?

Institutional Strategies

One approach might be through the development of true metropolitan government. By "metropolitan government" in this context, we mean some sort of governmental entity which performs a variety of services (or finances them) over all or a large portion of a metropolitan area—a general purpose agency with full governmental character, analogous to the state or the large central city. As has been noted, metropolitan government in this sense simply does not exist in the United States, except in those single-county metropolitan areas in which the county government plays a large role.

Nearly 100 of the standard metropolitan statistical areas comprise no more than a single county. Of these, twenty-four are located in states in which countywide local government units (county and county school districts) account for 60–80 per cent of total local government expenditure; effectively, such areas now do have metropolitan government. But about half of the single-county areas are areas in which the countywide units account for only about one-fifth of local expenditure, and another fourteen are areas in which the county share is less than 15 per cent. The high-county-share areas are mostly in the South. Expansion of the county role, to a level approximating that found in a number of areas in California (about 30 per cent of local expenditure), affords an obvious way of achieving the reality (but not the name) of metropolitan government in single-county areas (or in multiple-county

⁶² For a more extended discussion of this, based upon ideas suggested to me by Lynn A. Stiles, see Netzer, *Economics of the Property Tax*, pp. 216–17.

areas with only minor overflows of population from the primary counties).

Aside from this, the chances for true metropolitan government appear to be dim. The idea seems to have little popular appeal. Indeed, labelling an expansion of the county government's role as "metropolitan government" apparently greatly increases the unpopularity of this strategy, as the experience of Dade County, Florida, indicates. It is not difficult to understand the unpopularity of the proposal. First, as noted earlier, the residents of the presently advantaged communities are likely to resist any reorganization which threatens to diminish their existing fiscal advantages. Second, metropolitan government proposals frequently have been urged on the basis of claims for economies of scale over a wide range of functions, claims which are unpersuasive intellectually and which conflict with the superficial evidence of higher unit costs in the large cities.⁶³ Third, any radical change in that most conservative of institutions, local government, is likely to be acceptable only if the institution is generally perceived to be working very badly indeed. It is probable, as Vernon and Wood have separately argued, that few people other than the experts share this perception.⁶⁴

Ad hoc regional government devices clearly have far more popularity. The number of special-purpose districts and authorities has been increasing rapidly. According to the 1962 Census of Governments, there were (in that year), 5,411 metropolitan area special districts with sufficient autonomy to be classified as independent governmental units, an increase of 45 per cent in just five years. All but 179 of these units were single-function units, distributed by function as follows:

Fire protection	1,174
Natural resources (drainage, etc.)	946
Water supply	764
Sewerage	570
Housing and urban renewal	391
Other	1,387

Some of the relative financial magnitudes are shown in Table 6. The special districts accounted for about 7 per cent of local government expenditure in metropolitan areas, but because they specialize in capital-intensive services, they accounted for 15 per cent of capital outlay. The

⁶³ See Werner Z. Hirsch, "Implications of Metropolitan Growth and Consolidation," *Review of Economics and Statistics*, Vol. 16 (August 1959).

⁶⁴ Raymond Vernon, *Metropolis 1985* (Harvard University Press, 1960), pp. 224-28; Wood, *1400 Governments*, pp. 196-99.

TABLE 6.
SPECIAL DISTRICTS IN METROPOLITAN AREA FINANCES,
1962, BY FUNCTION^a

Function	Special district expenditure		Charges and utility revenue as per cent of special district expenditure
	Per cent of SMSA local government expenditure	Per cent distribution of special district expenditure	
Housing and urban renewal	41	18	46
Water supply	19	12	56
Transit	30	10	103
Sewerage	23	10	24
Airports and water terminals	38	8	64
Electric power	20	6	88
Hospitals	10	6	64
Highways	6	5	N.A.
Parks and recreation	11	4	12
Natural resources	36	4	33
All other	3	18	26
Total	7	100	50
Exhibit: Total capital outlay	15	44	—

N.A.—Not available.

^a Based on U.S. Bureau of the Census, *Census of Governments, 1962, Vol. V, Local Government in Metropolitan Areas*.

most important special district functions are housing, water supply, transit, and sewerage. Their more important functions account for 20 per cent or more of local expenditure. And they rely heavily on user charges, which in 1962 financed 50 per cent of total expenditure, compared to less than 20 per cent for all metropolitan area local governments.

These data overstate the significance of special districts as truly regional mechanisms. Fewer than 300 of the 5,400 special districts spend more than \$1 million annually; of these about 80 are housing authorities; 60, water and/or sewerage agencies; 30, hospital districts; and about 30 deal primarily with one or more transportation functions. These large transportation agencies mostly operate on a multicounty basis and a fair number of the large water and sewer districts operate on a countywide basis. But few of the other large districts (as defined here) operate on a geographic basis as broad as a single county. Many, including most of the housing authorities, are confined to a very small segment of their own metropolitan areas.

This indicates that the popularity of the ad hoc district or authority has not been sufficiently exploited to realize the potential for area-

wide solutions, where technology or other factors dictate such solutions. The popularity has obvious bases, including the appeal of price-like financing and "business-type" management for quasi-commercial services, and the ease with which debt, tax, and similar limits can be surmounted by the use of the ad hoc governmental entity. The authority or special district by itself, however, is hardly the ultimate in institutional strategies. For one thing, organization on a special-purpose basis does not guarantee that particular local government functions will be performed in an innovating manner. The ad hoc units develop their own institutional biases and blinders (in particular, they are notably resistant to the use of sophisticated pricing mechanisms),⁶⁵ and often are hesitant to venture into the new fields their technical competence and equity capital cushions (in the form of amortized revenue-producing facilities) equip them to enter. The continuous generation of new units, which is therefore usually necessary, both complicates the public sector decision-making process and contributes to a fair amount of dead weight losses in the form of political in-fighting.

An even more obvious defect of the ad hoc government strategy is its apparent unsuitability for tax-supported redistributive functions, even where the source of financing is not the major problem. Consider here the experience with housing authorities, very few of which operate outside the confines of a single city; evidently few places are willing to tolerate a situation in which an authority has the power to relocate the central city poor in other parts of the metropolitan area.

The most promising as well as the most crucial strategy is connected with changes in intergovernmental fiscal relations. This strategy can be so characterized for a number of reasons. First, as has been noted repeatedly, the residual responsibility for redistributive services at the local level is a large one and this should be assumed by higher levels of government. Second, the fundamental fiscal imbalance in our federal system has become both more apparent and more openly recognized, by both the experts and the political leaders. In brief, our system places the major responsibility for the provision of the most costly, most rapidly expanding types of public services on the states and their local subdivisions and, at the same time, effectively awards the most productive and flexible revenue sources to the federal government. The data make this clear. In 1964-65, the federal government directly spent \$25

⁶⁵ The Port of New York Authority, in an effort to promote bridge and tunnel traffic in its earlier days, adopted a pricing schedule which results in tolls which on the average are lower in congested peak hours than in the uncongested off-peak hours; although aware that this is in effect "fiscally perverse," the Authority has been unable to bring itself to end this pricing policy.

billion for civilian functions analogous to those provided by state and local governments (excluding social insurance), while state-local governments directly spent more than three times as much, \$82 billion.⁶⁶ Taking into account grants-in-aid, the federal government financed \$36 billion of ordinary civilian expenditure, or roughly one-third of the \$107 billion total; state and local agencies financed, from their own resources, the remaining two-thirds.

Between 1952 and 1964-65, a period in which the important changes in the rates of major federal taxes were *reductions*, federal revenues (excluding social insurance) rose by \$40 billion. This financed an increase in federal civilian expenditure (as here defined) of \$15 billion and an increase in federal grants of \$8½ billion. Meanwhile, state and local revenues from their own sources increased by \$44 billion, partly reflecting economic growth but also the consequence of repeated tax rate increases and new tax adoptions.⁶⁷ With the increase in federal grants, this financed an increase in state-local expenditure of nearly \$53 billion, an increase more than three times as great as that in ordinary federal civilian expenditure.

This, of course, is not a new situation. However, this inherent fiscal paradox, always implicit in the system, has become more apparent recently. It is now clear to all who care to see that a normal peacetime full employment situation provides the opportunity at the federal level for what Walter Heller has called "fiscal dividends"—buoyant federal revenues permit, indeed require, some combination of tax cuts and spending increases. Meanwhile, at the state and local level, governments struggle to find acceptable revenue devices, which means new and higher taxes, to match rapidly expanding demand for their services.

Third, recognition of this has resulted quite recently in a number of major new federal (and in some places, state government) programs involving substantial grants-in-aid and also direct federal assumption of responsibility, notably in the education, health, and (broadly defined to include anti-poverty programs) welfare fields. This can be viewed as a belated recognition of the national interest in the resolution of urban problems, with the increase in the federal role likely to level off at

⁶⁶ Data adapted from U.S. Bureau of the Census, *Governmental Finances in 1964-65*. Ordinary federal civilian expenditures, as defined here, exclude expenditures for these functions: national defense and international relations, space research and technology, farm price support, interest, and veterans services and benefits. All data in the comparison in this passage exclude social insurance operations.

⁶⁷ I estimate that effective tax rates rose, on the average, about 40 per cent, on the assumption that state-local revenues at constant effective tax rates rise about as fast as does gross national product.

a new higher plateau, much as it did between the late 1930's and the late 1950's. Or it can be viewed as no more than the beginning of a continuously expanding federal role. The historical precedents suggest the former interpretation, but there clearly has been change in intergovernmental relations in the past few years.

Intergovernmental Mechanisms

The available mechanisms for altering intergovernmental fiscal roles to enhance the output of urban services (accepting here the conventional undernourishment hypothesis) include fund transfers via conditional or unconditional grants or tax sharing, tax credit arrangements, and shifts in functional responsibilities to the higher levels of government. The potential and appropriateness of the latter, both at the federal and state levels, should not be overlooked.

In reality, both expansion of conditional grants and transfer of functional responsibilities to the federal government have occurred in the past thirty years, often provided for within a single Act of Congress. For example, the Social Security Act itself provided grants to the states for public assistance and, in addition, established a federally administered system of social insurance which was and is a partial substitute for public assistance. Most major pieces of health legislation in recent years have both enriched grants to the states and expanded the direct federal role, especially in medical research. Most of the education legislation similarly provides both grants to the states and federal loans and scholarships for individual students. The anti-poverty legislation and the Medicare legislation contain similar mixtures of grants and direct federal action.

Typically, expansion of the direct federal role involves federal performance of activities not previously performed by *any* level of government, rather than substitution of federal action for actual state-local action. But this is not necessarily the only possible arrangement. In fact, the model used here suggests that the federal government ultimately should handle all income-support programs through expanded social insurance arrangements (including federalization of unemployment insurance, in part to reduce interstate competition to lower payroll tax rates) and probably through the proposed negative income tax as well.

This would substitute for existing federally aided state and local income-support activities. As an intermediate goal, the model suggests immediate state government assumption of the entire public assistance function in the small number of very large urban states (like New York and California) where the function remains largely a local govern-

ment one and consumes large chunks of locally raised revenues. In addition, there is real scope for direct state government performance, in the absence of metropolitan-area-wide governmental machinery, of allocation branch services with important local spillovers. This is especially appropriate in states that are almost entirely urban.

Distributional considerations and obvious spillovers clearly justify many federal conditional grants, both actual and proposed. But once such cases are accommodated, it is hard to argue for much more in the form of federal conditional grants in this model. Local fiscal strains provide insufficient justification for federal action, which would override local consumer preference in favor of *inaction* and thereby move away from optimality. This lack of justification applies to a fair number of federal grant programs, it would seem, including urban renewal, open-space grants for local parks,⁶⁸ and perhaps even mass transportation.

Similar considerations should govern state government grant policy. At this level, much of the discussion traditionally has concerned the question of "anti-urban bias" in state grant provisions and formulas. No doubt there has been some of this, related to malapportionment of legislatures. But some of the apparent rural bias is inherent in the nature of the aided functions. For example, if states provide large highway grants, a substantial share is likely to go to the rural areas where the road mileage is; there is no discrimination if the distribution of combined direct state expenditure and state grants conforms reasonably closely with the distribution of highway use, as it does in many states.⁶⁹

The major problem in state aids may be in connection with large-city school systems. In most large central cities, the combination of relatively few public school children (that is, relative to suburbs) and relatively high business property values produces low state school aid, under apparently equitable state aid programs. But the equity is only apparent. The underlying assumption is that the cost of providing a given quality of education is uniform statewide. If it is not—if the provision of equivalent-quality education in the slum schools is as costly as is frequently alleged—then the conventional state aid formula is discriminatory.

Any number of variants are conceivable, providing for more or less

⁶⁸ See Henry M. Levin, "Estimating the Municipal Demand for Public Recreational Land" (Brookings, 1966, mimeo.).

⁶⁹ In New York, for example; see Mark A. Haskell, "Highway Finance Policy in New York State and New York City," in *Financing Government in New York City*.

unconditional (or at least very broad-purpose) federal grants to the states. The starting point for contemporary discussion of this type of device is the Heller-Pechman proposal.⁷⁰ The principal feature of this plan proposes per capita grants to the states. The plan would distribute a total which is equal to a specified fraction of the federal individual income tax base, a base which increases rapidly as the economy expands. This proposal would impose few limitations on the uses to which the states could put the new funds. Some proposed variants would restrict the use to health, education, and welfare purposes; this is not terribly restrictive, since expenditures for these functions financed from state and local taxes now account for at least 60 per cent of total tax-financed state-local expenditure.

Essentially, the case for unconditional grants rests on the fiscal imbalance argument, pure and simple: the need to transfer rapidly growing federal revenues to subnational governments. Externalities and distributive considerations provide support only for specially tailored federal action in particular functional fields. But general-purpose grants do afford one advantage, even within this model. If there is a federal interest, on the basis of externalities and distributive considerations, in a wide range of local activities, and if the differential degrees of federal interests are very hard to calculate or determine with any precision, then general-purpose grants are appropriate, to economize on decision-making in an atmosphere of indeterminacy.⁷¹

However, the major arguments for a Heller-Pechman type of plan relate to magnitude and simplicity. If the fiscal imbalance is of major proportions, as seems likely, it is important to develop a mechanism which will transfer large and growing volumes of federal funds and will do so with some assurance. The Heller-Pechman plan has this capability, since the funds provided will rise rapidly and automatically with economic growth. If the total distribution were set at a fixed percentage of the individual income tax base, it would come close to doubling in the next decade, without further action by Congress.

Another part of the argument is that such a scheme is a necessary supplement to expansion of federal conditional grants, since these are not likely to be sufficient to overcome the fiscal imbalance. If condi-

⁷⁰ See Walter W. Heller, *New Dimensions of Political Economy* (Harvard University Press, 1966); and Joseph A. Pechman, "Financing State and Local Government," in American Bankers Association, *Proceedings of a Symposium on Federal Taxation* (1965), pp. 71-84. See also Walter W. Heller, Richard Ruggles *et al.*, *Revenue Sharing and the City* (The Johns Hopkins Press for Resources for the Future, 1968).

⁷¹ This point was suggested by a comment by Harold Groves in *Public Finances: . . . Utilization*, p. 225.

tional grants are to be the solution, it is not enough to plead state and municipal poverty; one must have a plausible list of new and expanded grant programs, substantial in amount and related to activities in which it is conceivable that Congress may perceive a national interest.

Very large new and radically different federal programs usually have a lengthy gestation period, from initial public discussion to congressional adoption on more than a token scale. Therefore, the list of conditional grant alternatives to the Heller-Pechman route must include measures now in the public eye, if they are to have any effect in the next decade. The proponents of the unconditional grant approach argue that, aside from the poverty-linked services, there are no likely candidates for large new conditional grants. The one exception, perhaps, is in education. But even here, there is some evidence that problems connected with controls, segregation and the public-private school distinction may prevent the federal government from assuming a very much larger role.

The simplicity argument is partly based on the automatic features of the Heller-Pechman proposal. It also relates to the enormous complexity of subnational government in the United States. First, there are real differences in service needs, differences which should not be overridden by highly specified conditional grants which induce governments to take what are to them low-priority actions. Second, the distribution of responsibilities between the states and their local units so varies among the states that simple block grants to the states are far and away the easiest way to effect transfers of resources from the federal government to the state-local sector.

The opposing arguments have three main strands. First, there is the argument that per capita distributions are insufficiently equalizing among the states. To be sure, per capita grants are mildly equalizing (compared to, say, a revenue-sharing scheme in which the origin of the federal tax collections determines the distribution of the grants) and also are redistributive among individuals, if they substitute funds raised from progressive federal taxes for funds raised from more or less regressive state and local taxes. However, the equalizing effect is far less than might be achieved in other ways.

Second, opponents do not accept the essentially political judgment that the scope for large increases in conditional grants is limited. Therefore, they view the Heller-Pechman proposal as essentially competitive with conditional grants, not as a potential supplement.

Third, and perhaps most important, opponents view the simplicity of the unconditional grant and the flexibility it affords the recipient state governments, as major defects, not as virtues. There is no real

way of assuring that the additional federal funds provided in this manner will in fact be used to buy additional public services, rather than as a substitute for funds otherwise raised from state and local taxation. There is no assurance that the new funds, even if stimulative in effect, will stimulate the right services, those in which the nation as a whole has the greatest interest, like education. Finally, there is no assurance that the states will share the funds with local governments which so often bear the actual responsibility for the provision of the important services. In sum, the flexibility provides much opportunity for the continued undernourishment of the high-priority urban public services.

But is this apprehension realistic? Are not most state governments, in this urban nation, subject to similar types of pressures, pressures which impel them to maintain (and increase) tax efforts, spend for high-priority purposes, and aid local governments? This is suggested by the uses that state governments have made of their own additional resources in recent years.

Between 1952 and 1965 (to continue the earlier comparison), state government general expenditures financed from their own revenues increased by \$19 billion. The states disbursed 40 per cent of this increase (\$7.6 billion) in the form of aid to local governments, effecting an increase in the intergovernmental expenditure share of total state budgets. As for the functional distribution, 46 per cent of the \$19 billion increase went for education, 14 per cent for health and welfare purposes, 16 per cent for highways, and 24 per cent for all other purposes.⁷² In other words, the political pressures within the states led them to utilize their additional revenues in ways which most observers would agree are generally consistent with national priorities, mainly for redistributive-type services. It hardly seems likely that these pressures will change greatly in the years ahead and permit the states to "short-change" local governments or spend any revenues from unconditional grants on circuses rather than schools.

A final type of intergovernmental mechanism consists of tax credits, that is, credits against specified federal tax liabilities for all or part of specified state (and/or local) tax liabilities.⁷³ Federal tax credits have existed for forty years in the case of the estate tax and for thirty years in the case of the unemployment insurance payroll tax. The new thing in recent proposals, notably that of the Advisory Commission on Intergovernmental Relations,⁷⁴ is that they apply to a form of state taxation

⁷² Data adapted from the *Compendium of State Government Finances* for 1952 and 1965.

⁷³ The standard work is James A. Maxwell, *Tax Credits and Intergovernmental Fiscal Relations* (Brookings, 1962).

⁷⁴ In *Federal-State Coordination of Personal Income Taxes*.

which, unlike the existing tax credits, is felt by large numbers of individuals—the state income tax. The Advisory Commission proposal is explicitly designed to encourage the states to utilize the individual income tax much more heavily. In two-thirds of the states the income tax is not effectively exploited at present. It is the only major type of tax not used heavily by the state-local sector at present (in the majority of states), and it has various advantages over other types of state-local taxes, notably its lack of regressivity and its high revenue growth potential.

The tax credit proposal makes a good deal of sense if the main impediment to wider state use of the income tax is the fear of interstate competition for economic development: by lowering the net cost to taxpayers, the tax credit will reduce the absolute size of the disincentive feature (although states with high income tax rates will remain in the same *relative* position, short of a 100 per cent tax credit). But if the real reason for reluctance to use the income tax is simply a difference in values among different electorates—a preference for less income redistribution in some states—then the tax credit is an imperfect device for enforcing national uniformity in income redistribution by means of taxation.

In any event, this, like most other tax credit proposals, is concerned more for the “quality” of tax systems than it is for increasing the total output of public services. Its contribution to the latter goal inevitably will be a modest one, in comparison with the approaches discussed previously.

In summary, the analysis here suggests the following as the appropriate courses of federal action, to move toward the model multilevel system of public finance in metropolitan areas (presented more or less in order of the author’s priorities):

1. Federal assumption of direct responsibility for all income-support programs.
2. Greatly increased federal financing, presumably via conditional grants-in-aid, of other public programs linked to poverty, programs which redistribute income in kind, such as health and hospital services, social services to children and families and special educational services for disadvantaged children.
3. Expansion of other federal conditional aids *only* to the relatively minor extent that real and substantial interstate and interregional spillovers are involved.
4. A major federal program of general-purpose grants to the states.
5. Some type of federal credit for state (and local) income tax payments.

METROPOLITAN CHANGE AND FISCAL INSTITUTIONS

The model multilevel system utilized for this paper can accommodate a fair amount of urban growth and change. That is, its prescriptions are likely to be as valid (or invalid) a decade hence as they are today. An ideal system may be constant over time, but actual fiscal institutions are not. What is the likely effect of urban growth and change on fiscal institutions? Or putting it another way, in the light of expected environmental changes, are the policy prescriptions discussed above likely to be more or less readily acceptable than they are now?

The most important environmental changes can be summarized in two old bromides. First, the country is becoming more metropolitan in the senses that (a) more of the total population lives in metropolitan areas and (b) more of the metropolitan area population lives beyond the central cities and therefore is likely to be accommodated by a fragmented governmental structure. Second, individual metropolitan areas are becoming more alike, in economic mix, income levels, population composition, and cultural amenity.

These changes together suggest that institutional changes effected in one area are likely to be imitated or replicated in other areas more quickly than heretofore. If the states have the real capacity to be experimenters and innovators, as has been so often asserted by writers and so little demonstrated in practice, this should make for an exciting prospect in regard to forms of governmental organization and arrangements for the provision of public services, including possibly better utilization of user charge devices.

But these processes are also likely to bring about greater uniformity in state-local tax systems. Greater uniformity, in turn, is likely to increase local reluctance to make tax changes which will make the tax system of an individual area or jurisdiction appear to depart greatly from that found in competitive locations. If the state-local sector continues to expand relative to the national economy, with consequent revenue pressures at the local level, solutions in the form of shifting administrative and/or financial responsibilities to higher levels of government will become increasingly attractive. The sheer weight of an increasing metropolitan population would work in this direction, as well. As has been argued earlier, an increasing role for the federal government in regard to redistributive services is highly desirable, but an expansion of the federal role may be on balance inefficient with regard to a wide array of allocation branch services.

It is also a reasonable presumption that intrametropolitan spillovers will increase over the years. This is *not* a consequence of increasing intrametropolitan economic interdependence. Indeed, with the decen-

tralization of economic activity within urban areas, economic interdependence is probably declining; the high point in interdependence was probably reached some years ago when most suburbs were largely dormitories for the central cities. The increase in spillovers is, instead, a result of technological change and linkages and rising aspirations with regard to public services—greater demand for air and water pollution control, for regional park and recreation facilities and for other services which can be provided only on an area-wide basis. This suggests an increasing reliance on area-wide governmental machinery, but more in the form of ad hoc regional machinery than of general-purpose metropolitan government.

Will intrametropolitan fiscal disparities increase? The controversy about whether in fact there is already an observable trend toward uniformity was noted earlier in this paper; the results of the controversy to date are inconclusive. But if in fact there is a shift in the responsibility for redistributive services to higher levels of government, it seems inevitable that disparities in resources relative to needs will decline, not increase. And a reduction in these disparities makes a Tiebout-type solution for the remaining (purely local) allocation branch activities both more feasible and more attractive.

As an aside, it should be noted that one of the more objectionable consequences of existing disparities may be a passing phenomenon in most areas, even in the absence of changes in intergovernmental fiscal relations. This phenomenon is "fiscal zoning," controlling land use to maximize tax base and minimize service costs. Fiscal zoning has its greatest attractions when jurisdictions are very small in geographic extent—when the location of a single large plant or shopping center or residential subdivision can make a real difference in the fiscal position of a small school district or other unit. However, as metropolitan areas grow outward, urbanization increasingly reaches into territory where there are few large jurisdictions rather than many small ones. For example, in the New York region, most of the 1946–60 development occurred in a 1,000-square-mile ring served by 520 units of government; in the current decade, the development is occurring in a 3,600-square-mile ring with 700 units; and in subsequent years development is likely to shift to a 2,000-square-mile outer ring with only 300 units. Fiscal zoning is likely to be considerably less attractive when the average unit covers 10 square miles than it is when the average unit covers less than a single square mile.

Finally, we must note the possible effects of some changes which are national, not merely metropolitan. Increasing population leads to various kinds of resource constraints. These are not absolute con-

straints, but constraints in terms of relative costs and alternative uses—notably constraints connected with land, water supply, and clean air. It is reasonable to anticipate that such constraints may increase the readiness to use sophisticated pricing mechanisms to ration the existing supply, to curb external diseconomies, and to guide new investment. Technological change has converted such mechanisms from far-out science-fiction notions to immediately practicable schemes, schemes consistent with the increasing perception of our world as “spaceship earth” rather than as one with an abundant exploitable frontier.