Regional Tax Base Sharing: Possibilities and Implications

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The real possibility that the continuing New York City fiscal crisis foretells the fiscal fortunes of many other large central cities underlines the need for a sweeping reform of the entire system of intergovernmental relations in this country. What is needed is a serious reconsideration of the balance between the tax base and public expenditure needs at all levels of government; federal, state, and local. The primary concern in this paper is with only one dimension of the intergovernmental system—the relationships among cities and their suburban local governments. More specifically, the issues raised here have to do with the efficiency and equity implications of regional tax base sharing. Our basic conclusion is that regional solutions in their most likely form will do little to alleviate the urban fiscal problem. Only if the structure of regional tax and spending schemes is markedly changed will regionalization improve the fiscal position of cities without harming the real income of the urban poor.

Though our focus is solely on the intraregional aspects of intergovernmental reform, we acknowledge that such reform proposals can be properly evaluated only in a context of accompanying federal/state and state/local reforms. In this sense, our approach is very much a partial equilibrium analysis.

In the following section we describe the possibilities and devices for regional financing. We turn then to an evaluation of their equity and efficiency implications. To the extent there is a contribution here, it is to challenge what we see as the conventional wisdom—that the major benefit of regional taxation, a capturing of the rich and growing suburban tax base, more than outweighs all the disadvantages. What is argued here is that there are notable disadvantages of regionalization, which can be offset only by a proper structuring of the financing mechanism.

The fiscal problems of New York City differ in degree from those of other large central cities, but the underlying economic weaknesses that are the root cause of New York City's crisis afflict many other cities as well. The deterioration of the central city economic base, whether measured in terms of jobs or income, is a widespread phenomenon affecting some central cities even more severely than New York City. The rapid inflation of recent years has reduced the net purchasing power of local governments substantially, increasing the cost of the goods and services they utilize by more than it increases their revenue bases. The cost of public employee compensation, especially fringe benefits, has risen rapidly in recent years, and finally, the current national recession has reduced tax receipts of local governments while increasing pressures on their social service expenditures.

There are essentially four alternatives for cities facing this fiscal dilemma. First, increased intergovernmental aid from either the federal or state level can be used to relieve the financial squeeze. Second, the states or the federal government can assume complete responsibility for some public functions, such as welfare. Third, city governments can raise their own taxes (if permitted by the state). Finally, hard-pressed cities may be relieved to some extent by various forms of regionalization of taxes and/or expenditures, the subject of this paper.

II. FORMS OF REGIONALISM

The two basic elements in regional governance are the delivery of services and the financing of those services. The range of possibilities for metropolitan fiscal reorganization run from area-wide general government to area-wide special purpose government to various forms of regional taxation. On the service delivery side, the crucial dimension is the geographic extent of the area served. On the financing side both the geographic area of the revenue base and the nature of the base are crucial characteristics in defining a regional system. Since our primary concern here is with revenues, we will cross-classify the available alternatives for regional financing according to these two elements of geographic area and tax base.

The alternatives for metropolitan fiscal organization vary from no regionalization to complete metropolitan government. The geographic dimension of revenue bases can be central city residents (the case of no regionalization), central city employees (some sharing of central city expenditure burdens with commuters), special district residents, central county residents, or all residents of the region. The latter three categories may coincide or overlap in some cases. The major revenue base alternatives are intergovernmental aid, retail sales, income, property values, and user charges. Let us briefly identify these revenue sources individually before we turn to an evaluation of their economic implications. We begin with the case of no regionalization, where the geographic area of the central city is the statutory tax jurisdiction.

Various central cities levy taxes on general retail sales, on specific retail sales, on income, and on property values. They also receive revenues from higher levels of government and from user charges. General sales taxes are levied by cities in twenty-seven states and account for roughly ten percent of municipal tax revenues nationwide. In eighteen states, cities levy special sales taxes, usually on alcohol, gasoline, or tobacco. These special sales taxes account for a slightly smaller share of municipal tax receipts than general sales taxes. Only ten states have cities with income or earnings taxes, but these taxes account for just over ten percent of all municipal tax revenues in the nation. This tax category includes taxes on the income of residents (as in Washington, D.C.) and on earnings of commuters (as in most other cities with an income tax). The principal source of city tax revenues, the property tax accounts for nearly two-thirds of municipal tax revenues and is levied by cities in all fifty states. Intergovernmental aid and user charges also provide revenues to cities in all fifty states. Each of these two revenue sources accounts for about 20 percent of total municipal general revenues, while taxes account for the remaining 60 percent.

The only regional element in this list of city taxes is the earnings tax on commuters, and this type of tax accounts for a very small share of city revenues.

In general, special districts are a step toward greater regional responsibility. In 1972, more than half of all special district revenues were raised in districts overlying central cities of SMSA's. Special districts offer an incremental approach to regional government. Furthermore, this pattern of revenue sources varies somewhat with city size. Large central cities rely somewhat more heavily on nonproperty taxes and raise significantly more revenues per capita from their own sources. For this reason, there has been considerably less opposition to regionwide special purpose districts than to more sweeping regional reorganizations and their numbers have been rising in recent years. Particularly in the area of mass transit services, it has been possible to combine area-wide service delivery and financing. Regionwide general sales taxes have been used to finance transportation in some cases (Atlanta's MARTA and San

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Francisco’s BART) and there has been frequent use of regionwide property taxation. In one case (Syracuse’s CENTRO) the county mortgage tax is used to finance regional transportation. The other area where regional tax practices have been widely used is education finance, usually levied on a district or a countywide basis in property. Other regionwide special purpose governments tend to be financed by user charges.

Countywide taxes are also a step towards regionalization of the public sector. In general, counties rely more heavily on intergovernmental aid and the property tax than cities. Nonproperty taxes accounted for only 6.1 percent of county general revenues nationwide in 1971–72, while they were the source of 17.4 percent of municipal general revenues. Intergovernmental aid to counties was 42.1 percent of general revenues in 1971–72, while intergovernmental aid to cities was only 32.9 percent.7

The final step toward regional fiscal responsibility is the levying of general purpose taxes on a regionwide basis. This step can be accompanied by metropolitan governance or its revenues can be distributed among jurisdictions in the region.

Metropolitan general purpose governance regardless of its inherent advantages and disadvantages, is not likely to be a major component of intergovernmental fiscal reform in the near future. Historically, the experience with consolidations has been scant and suburban voter opposition has been strong.8 Apart from the political opposition to consolidation from suburban residents in general, there are the enormous problems associated with multistate SMSA’s.9 There has, of course, been much more success with annexation in the ‘newer’ urban areas of the South and West. But in the Northeast and North Central regions where city fiscal problems are most severe, large annexations are a rarity.10 Given these bleak prospects for metropolitan government, we do not consider it as a viable option in the balance of this paper.

When most academics and practitioners discuss regionalization of the tax base, the preferred form is the shared areawide or at least countywide general purpose tax. There has been little or no experience with general purpose regional income taxes, except for the local option surcharge on the state income tax as in Maryland. Regional property taxation for general purposes has not been widely used, with the now well discussed Minneapolis program a notable exception.11 The most common form of regional taxation is the countywide sales tax. However, of the 25 states levying such taxes, only six make any provision for distribution among jurisdictions within the county on a basis other than origin of sales.12

In sum then, historical experience would suggest that if politically acceptable regional solutions to the urban fiscal problem are to be found, they are more likely to be in the form of special purpose areawide taxes, and increased use of city government sales and income taxation.

III. THE CASE FOR REGIONALISM

The theoretical and practical pro and cons of regional provision and financing of urban services are well discussed in the literature.13 The arguments in favor of an areawide financing mechanism are the internalizing of external effects, the capturing of scale economics, the reduction of expenditure (service level) disparities, and the capturing of the suburban tax base and its growth. The counter arguments are that such schemes impose efficiency losses by reducing local control over the package of services delivered; they are apt to be costly and they may heighten the overall regres-

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3. In 1976, 96 of the 266 SMSA’s were multistate and 5 of them extended into more than two states.
6. Advisory Commission on Intergovernmental Relations, Local Revenue Diversification, p. 47.
sivity of the tax burden distribution. In essence, these arguments require a choice between local autonomy and equity; alternatively, a compromise such as two-tier government may be the preferred solution. Let us examine these arguments individually in the context of the taxing alternatives identified in the previous section. We begin with the arguments related to economic efficiency. Since these efficiency questions are primarily expenditure or service delivery issues, the tax alternatives are not treated separately until we turn to the question of tax and service equity.

**Externalities**

Benefit spillovers across jurisdictional lines are a legitimate justification for regional financing. In the absence of a financing mechanism which requires all service recipients to pay their share of service costs, too little of the service will be provided, generating economic inefficiency. The problem with this argument in the case of most public services is that the efficiency losses resulting from externalities and indeed the externalities themselves are extremely difficult to measure. In practice, therefore, it is difficult to use the concept of externalities to justify regional taxation in the face of generally strong opposition.

**Scale Economies**

To the extent that they exist, scale economies are also a legitimate justification for regional consolidation of public services. However, there is little evidence of scale economies beyond those hardware functions (sewers and water), which have long since been consolidated in most metropolitan areas.

Thus, scale economies are in the same category as externalities: they are theoretically valid, but they lack the empirical evidence necessary for policy application.

**Local Preferences**

The major efficiency disadvantage of regionalization stems from the nonexclusive nature of public services. If two groups of people within a region prefer different levels or different mixtures of various public services and different tax levels to finance them, they cannot be accommodated in the same taxing and servicing jurisdiction without an efficiency loss to one or both groups. For example, suppose central city apartment dwellers would prefer to tax themselves to provide ample public park space while suburban residents with private yards would prefer lower taxes and fewer parks. In separate jurisdictions, both groups satisfy their preferences. In a regional financing system, central city residents would get fewer parks and/or suburbanites would pay higher taxes. Alternatively, the inefficiency could take the form of suburban residents relocating outside the boundaries of the taxing jurisdiction and commuting farther to their daily activities. This could pose severe problems for the metropolitan area in the long-run. This argument against regional financing, however, suffers from the same shortcoming as the previous two arguments in favor of regionalization: although there is some evidence that they do exist, these efficiency costs are not measurable with any degree of confidence.

**Costs of Regionalization**

The final efficiency argument relating to regional financing of public services is that there is a leveling upward of services and compensation rates when consolidation initially occurs. There is some evidence for this argument, although there are too few examples for a definitive analysis. This leveling upward may have two costs. First, it may raise service levels and hence taxes about their preferred levels. Second a leveling up of employee compensation rates may not be accompanied by concomitant increases in the quality or quantity of services received. In this case, there may be a net loss of efficiency regardless of service level preferences.

In sum, the efficiency arguments, both for and against regionalization, are far too

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weak empirically to justify a strong position on the issue on these grounds alone. Thus, we turn to the question of equity.

The two basic equity issues related to regionalization are fiscal disparities and the overall regressivity of the tax system. These issues provide a somewhat more tangible basis for evaluating regional financing of public services.

**Fiscal Disparities**

While measurement problems are severe and both data and analysis are dated, there apparently are marked differences between metropolitan city and suburban areas in per capita expenditures, tax effort, and per capita aid flows. The available evidence indicates that per person noneducation spending and aid, and tax effort are all higher in central cities, and that per person education spending and education aid are higher in suburbs.

The most frequently cited reasons for this pattern of fiscal disparities are the uneven distribution of wealth between city and suburban residents which leads to a greater (unused) capacity to finance in suburbs, and the overburden of noneducational services on central city budgets. The latter is argued to lead to suburban spending for education at about 50-60 percent of the total budget while core cities spend for education at a rate of about 35 percent. Although more recent data and estimates than the 1972 ACIR computations are not available, the trend between 1957 and 1972 does not suggest any marked change in this pattern.

On the subject of city/suburb tax effort disparities, more work is necessary before the case for higher city effort is convincing. Ignoring for the moment the problems of defining "tax effort" and measuring personal income disparities between city and suburb, Sacks and Callahan estimate 1972 per capita taxes at $235 in central cities and $181 outside central cities. This per capita difference, however, does not imply a 30 percent difference in tax burdens. It overstates the burden difference because the core city is likely to export part of its tax burden. A substantially greater portion of central city taxes are levied directly on business firms or on suburban residents as commuters or shoppers in the central city. At the same time, these tax burden estimates understate the burden difference because income and taxable capacity are greater in the suburban areas and because a larger share of the income-generating activity in the city area is likely to be (property) tax exempt. The net result of these complications is a disparity in tax burdens of undetermined magnitude. The 30 percent disparity in tax receipts per capita strongly suggests the existence of a disparity in per capita tax burdens as well, but whether the burden differential is greater or smaller than 30 percent is not known.

Whatever we conclude about disparities, it is clear that regional taxation schemes will have a major impact on the distribution of tax burdens in the region. If central cities are forced to rely on their own resources, the resulting increases in city sales and income taxes will heighten the difference in tax effort between city and suburb and will raise the tax burdens of city residents more than suburban residents. This occurs because of a combination of inducements for suburban shopping, lower effective rates on suburban than city residents, and the greater proportion of consumption in the city by city residents. This alternative is really an increasing levy on a declining base and may have deleterious long run effects. In the short run, however, it may produce substantial new revenues for cities; for example, income and sales taxes account for major shares of the local budget in Philadelphia, New York, and Columbus. The increase in taxes which include commuters will provide increased funds which may reduce expenditure disparities but at the cost of greater tax burdens on the urban poor, and undesirable long run effects on growth in the local economy.

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17 The most important of these measurement problems is the allocation of countywide expenditures between central city and suburban areas. Most commonly, this has been done by using a population allocator. For more discussion of this point, see Seymour Sacks and John Callahan, "Central City Suburban Fiscal Disparity," Appendix to Advisory Commission on Intergovernmental Relations, City Financial Emergencies, (Washington, D.C.: G.P.O.) 1973.

18 Sacks and Callahan, "Central City Suburban Fiscal Disparity."
The alternative is to turn to area wide tax levies distributed on an equalizing basis. Here there is a potential for a substantial reduction in metropolitan fiscal disparities. The level of resources raised from a given percent yield can be substantially increased if the suburban base is included. Thus, if there is a distribution formula which diverts funds to the core city, expenditure disparities could be markedly equalized.

The key to this reduction in disparities is the distribution allocator. Origin of sales, income earned, or population allocators are not good long-run solutions for the city because of the decentralization of economic activity in metropolitan areas. Resident income is not easily measured, though in theory it would seem appropriate. The best combination would be a per capita distribution adjusted for full value of taxable property and numbers of families below some minimum income level. Such a scheme produces a decided equalizing of tax burdens among the city and suburban jurisdictions if the tax base is income. If the base is sales or property, the burden (tax as a percent of taxable capacity) is likely to fall more heavily on the core city where consumption and rent account for a larger fraction of personal income.

This issue of the distribution formula for regional tax base sharing raises an aspect of fiscal disparities that is often overlooked. This is the existence of disparities among individuals as well as among jurisdictions. These two types of disparity are related, of course, but a system which equalizes per capita tax burdens among jurisdictions but stops short of metropolitan government does not necessarily equalize tax burdens among individuals with the same income. In particular, central cities with a much larger share of residents at or below poverty income levels may impose greater burdens on these residents than suburban jurisdictions impose on their low income residents.

As noted above, only six states attempt any redistribution of county sales taxes, and not all redistribute on an 'equalizing' basis. Regional property tax sharing, as in Minneapolis, represents an attempt to equalize tax burdens but the amounts involved are very small. There is little evidence of area wide general purpose income taxation. Thus, the most likely forms of regional taxation are those least likely to reduce metropolitan fiscal disparities. Disparities offer a stronger case for fiscal regionalization than the efficiency arguments, but they too, have important drawbacks as a solution to the urban fiscal crisis.

Regressivity of the Tax System

If property and sales taxes are the most likely focus for regional taxation, then regional financing may very well increase the overall regressivity of the local tax system by changing the mix of taxes used to finance social expenditures. In particular, central cities rely more heavily on nonproperty taxes than smaller suburban jurisdictions. The distribution formula for regional tax sharing may also increase the system's regressivity because central cities have expenditure responsibilities which are disproportionately large relative to the usual distribution criteria of population, income, or origin of sales. These responsibilities include downtown and cultural activities which serve the entire region (externalities) and a large proportion of low-income residents. To the extent that regional tax financing of public services is a substitute for greater state or federal aid to central cities as a solution to the urban fiscal crisis, the regressivity of the overall tax system is increased still further.

The net equity effect of regional sales or property taxation, then, is a likely increase in the regressivity of the tax system accompanied by a likely (small) decrease in central city-suburban fiscal disparities. The net effect on the tax burden of low-income central city residents is not clear. Thus, the case for fiscal regionalization is ambiguous on efficiency grounds as well as on equity grounds, at least until we know a great deal more about the magnitudes of these effects.

Capturing the Suburban Tax Base

In addition to the efficiency and equity arguments, there is the question of the revenue yield of regional taxes. This question has both efficiency and equity aspects since it is related to the issue of the size of the public sector. These aspects are thoroughly discussed in the literature so we will focus our discussion on the likely magnitude of the revenue "bonus" to the central city if

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a regional financing system were adopted. The basis for this argument for regional taxation is the capture of the wealthy suburban tax base and the potential tax revenues associated with the growth of economic activity in the suburbs. This proposition depends on a substantial trend toward decentralization of population and employment within metropolitan areas.

Probably nowhere better is such a trend exhibited than in New York City. Indeed, this decentralization is in large part responsible for the depth of New York City's fiscal crisis. For example, between 1965 and 1972, New York City experienced a net loss of just over 4,200 jobs while its suburbs gained more than 348,000 jobs. In percentage terms, New York City lost about 0.1 percent of its employment base while the suburbs increased their employment by 16.3 percent. If Essex County which includes the city of Newark, and Hudson County which includes Jersey City, are excluded from the suburban growth figures, the growth rate of New York City's suburbs rises to 21.9 percent.

This pattern of decentralization is not restricted to New York City. Population growth in central cities of SMSA's grew only 6.4 percent between 1960 and 1970 while their suburbs grew 26.8 percent. Jobs also suburbanized in other metropolitan areas, although the available data are not as comprehensive since they are available only for cities which are coterminous with counties. Philadelphia and St. Louis, for example, both lost jobs between 1965 and 1972 at a faster rate than New York City.

It is alleged that regional taxation is a partial answer to this decentralization in that it is a way for the central city to retain or recover its tax base. But under present forms of regional taxation, this effect is not accomplished. City commuter and sales taxes do not touch the suburban shopping center or manufacturing plant, though they do pick up city workers and shoppers who have moved to the suburbs. Certainly in the long run, these taxes offer no real contribution to the urban fiscal problem.

Consider, for example, the case of shifting the financing of a specified package of services from a city property tax to a regional sales tax. A recent case study in Atlanta demonstrates that such an adjustment would raise aggregate tax liabilities in the central city and increase the tax burden at all income levels. This results in part because of a switch from a property tax, much of which is paid by firms which export it outside the region, to a direct personal tax which cannot be exported.

If, on the other hand, the proceeds of this tax are redistributed on a needs basis then there will likely be favorable incidence effects on the expenditure side. This conclusion, however, must be qualified by the possibility that the availability of additional funding will merely bid up the level of city employee wages and have little by way of an effect on real benefits.

The final irony in the capture of regional tax base growth is that the most likely geographic area for regional taxation is the county and central counties of large SMSA's are themselves growing at a much slower rate than the newer suburbs farther away from the central city. This point is well illustrated by the growth rates of employment in a sample of 54 of the largest 72 SMSA's, excluding single county SMSA's and New England SMSA's: central county employment in these 54 SMSA's grew at an average annual rate of 1.4 percent between 1967 and 1972, while employment growth outside the central counties averaged 5.0

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percent annually during this period. Furthermore, fiscal disparities appear to be as severe between these 54 central counties and the rest of their SMSA's as for central cities. Noneducation expenditure per capita for the central county areas (including all local governments) was $336 in 1972 while it was only $215 in the rest of the SMSA's. A large part of both the growth differential and the fiscal disparities can be attributed to the presence of the central cities in these central counties, but the point of our argument is that the noncentral city portion of the counties is neither large enough nor wealthy enough to solve the central city fiscal problem singlehandedly.

The evidence strongly suggests that the trend toward decentralization of economic activity in urban areas affects the long-run viability of the central county tax base as well as the central city tax base. It indicates that any fiscal dividend to central cities from countywide taxes will be relatively small and hardly of sufficient magnitude to deal with the urban fiscal crisis.

IV. CONCLUSION

The outlook for regional financing as a solution to the serious fiscal problems facing many of our large central cities appears rather dim. Among the available regional options regarding tax bases and tax jurisdictions, countywide sales or property taxes seem to be the most widely used at the present time and the most likely to be adopted in the future. These two forms of regional finance do not provide an unmitigated blessing—even for those they are supposed to help most. The loss of local autonomy and the potential cost of leveling up service and wage levels at least partially offset the internalization of spillover effects and the economies of regional scale so that the effects of regional financing on the economically efficient provision of public services are not clear. The relative regressivity of local tax systems, especially in suburban jurisdictions, also partially offsets any potential decrease in central city-suburban disparities in tax and expenditure burdens, so that the equity implications of regional financing are also unclear. In any case, the regionalization of sales or property taxes is not likely to reduce disparities among income classes very much if at all, regardless of the interjurisdictional impact of these taxes. Finally, there does not appear to be sufficient revenue capacity in the central counties of many large SMSA's to generate the magnitude of fiscal help needed to solve the urban fiscal crisis. Thus, we conclude that in their most likely form, regional financing mechanisms will not be adequate to deal with the fiscal problems of large central cities and indeed may even exacerbate them. This gloomy forecast is at odds with the prevailing opinion of many urban observers who fail to distinguish among the forms of regionalization. Unfortunately it is precisely the most likely forms of regional financing that offer the least in terms of benefits. Although many questions remain to be answered, other solutions such as increased federal or state aid, federal or state assumption of greater functional responsibility, and full-fledged metropolitan government may be more equitable and perhaps even more efficient response to the fiscal woes of large central cities.