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Metropolitan Fiscal Disparities

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INTRODUCTION

A widespread academic and policy concern with urban fiscal problems, and with city-suburban fiscal disparities dates back to the early 1960s. Campbell and Sacks, writing about metropolitan fiscal disparities in 1967, said that:

Of particular importance... is that the impact on service needs caused by the “sorting out” of population that is taking place within metropolitan areas. The resulting pattern of different kinds of service needs in central cities and their outside areas becomes one of the most crucial metropolitan aspects of the service issue. Of most concern currently is the adequacy of those services for the poor who reside in increasing numbers in central cities.

Twenty five years later, a National League of Cities report states that:

Major demographic shifts are also causing increased disparities between cities and suburbs. More than 5.5 million more people lived in poverty at the end of the decade of the 1980s than 10 years previously. Over this period, poverty became increasingly concentrated in the nation’s central cities. These trends result in systematic differentials among localities in income, wealth and poverty. These differences create fiscal stress in central cities. Changes in the intergovernmental system are compounding these disparities and increasing the fiscal squeeze on cities as they attempt to respond to these problems.

The questions we raise here are:

1. how have fiscal disparities changed since the late 1950s;
2. how might we explain the existence of fiscal disparities;
3. how have federal, state, and local policies affected this situation; and
4. what are the prospects for the future?

*This paper updates and draws heavily on Bahl, Martinez and Sjoquist, 1992.
TIGHT BUDGETS: CAN CITIES PICK UP THE BURDEN?

DEFINING AND MEASURING FISCAL DISPARITIES

We might best start with a working definition of fiscal disparity. One approach (Bahl, 1970) is to define a revenue-resource gap.

\[ d = R + F + S - N \]

where:
- \( R \) = revenues raised from own sources area from a representative tax system,
- \( F \) = federal aid,
- \( S \) = state aid,
- \( N \) = expenditures required to produce a “standard” package of local public services, standardize by using per capita amounts.

Variations across metropolitan areas in the value of the gap for central cities describe the relative fiscal problems of urban areas, whereas variations in the gap across local governments within a metropolitan area is the fiscal disparities problem.

A resource-requirement gap is more easily conceptualized than measured. A few studies have attempted to estimate something like this resource-requirement gap. Bradbury, et al. and Ladd and Yinger (1989) propose definitions that follow the idea of a gap. The strength of this approach is that it is more true to the idea of measuring differences in the need of assistance, e.g., for equalizing intergovernmental aid. The weakness is that it requires estimation of the cost of providing a standard package of services, and it is arguably true that the correct cost determinants have not been identified and that consumer preferences have not been controlled for.

Perhaps for these reasons, most studies have started by examining disparities in per capita expenditures, taxes, and aid. There is no attempt to adjust the initial baseline measure of disparities for differences in need, in tax effort, or in preferences for public versus private goods. The raw disparities in per capita expenditures are acknowledged to be due to some combination of choice, environmental factors, resource endowment, etc. Most of these studies then turn to an explanation of these city-suburb differences, usually in terms of needs, resources and environmental differences. Campbell and Sacks (1967), Sacks and Callahan (1973), and ACIR (1984) are all in this tradition. Our work is also in this tradition. Raw differences in per capita expenditure are the basic measure of disparities that we track over time and try to explain.

CHANGING PATTERNS OF DISPARITY

The first task is to document the extent of fiscal disparities between the central city and the suburbs. To this end, we build on the ACIR (1984) study of fiscal disparities by adding 1987 observations for a sample of 35 large MSAs. The results of this analysis show that the expenditure disparity between city and suburb in 1987 was 1.51, i.e., cities spent $1.51 per capita for every $1.00 spent by suburban governments.

On the financing side, the per capita level of taxes remains about 25 percent higher in cities than in suburbs. However, when this level of taxation is adjusted by income, the results suggest that the overall level of tax effort is 52 percent higher in central cities than in the suburbs. The pattern over the past 3 decades has shown a declining disparity in per capita tax revenue for the central city relative to the suburbs, but a constant disparity in tax burden in favor of the suburbs.

To what extent has the federal and state aid system been structured to reduce these disparities, or at least to relieve some of the fiscal disadvantage of central cities? In 1977, central cities received $1.69 in state and federal aid for every $1 received by suburban governments. By 1987, this advantage had fallen to $1.53. This is due to the phasing out of the big urban federal aid programs, and to the fact that state governments have not stepped in to offset this decline.

Surprisingly, this story about city and suburban fiscal disparities holds across all regions, though there is some variation in the extent of the disparity. The pattern in southern and western MSAs seems to be one of less disparity, less federal and state aid equalization, and higher relative levels of city taxation.

EXPLAINING THE TREND IN FISCAL DISPARITIES

Before we look for “solutions” to the problem of metropolitan fiscal disparities, we must understand why these disparities exist. Why do cities spend more or less in total than do suburbs, i.e., is it because of a preference for a larger government sector, special needs that make costs higher, a less efficient delivery system, an economic development choice, etc.?

To study the determinants of public expenditure levels in cities and in suburbs, we estimated a regression to explain city-suburb expenditure disparities. For control variables on the demand side we employed family income,
intergovernmental aid, and a consumer price index for the MSA. For control variables on the cost side, we used the total number of governmental units in the metropolitan area (absolute number and in per capita terms) as a proxy for the levels of government efficiency. We also used dummy variables for whether the central city also was the state capital. We do not control for the prices of labor, capital, and other inputs because we assume that all jurisdictions in the MSA hire inputs in the same markets. Differences in costs of provision due to differences in socio-economic environments are proxied by the incidence of violent crime in the central city and outside the central city, the relative importance of minority (black) population, the relative importance of population without a high school diploma, and the age of housing. The fiscal interdependence between the city and the suburbs was proxied by the employment-to-population ratio in and outside the central city, with employment measured on an establishment basis.

Among the demand variables, only two, average real family income for residents in the jurisdiction, and per capita state and federal aid relative to the average family income in the jurisdiction, were statistically significant. The population of the suburbs vis-a-vis the central city never was statistically significant. On the cost side, all the environmental and efficiency variables failed to perform on a consistent basis. The fact that none of these variables was statistically significant may be due to the fact that CC and OCC expenditures in the dependent variable are measured inclusive of state and federal aid.

### Table 1

<table>
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<tr>
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<tbody>
<tr>
<td>CC Average Family Income</td>
<td>1.15 (2.81)</td>
<td>1.20 (2.09)</td>
<td>1.05 (2.74)</td>
<td>0.15 (0.24)</td>
</tr>
<tr>
<td>OCC Average Family Income</td>
<td>-0.51 (1.20)</td>
<td>-1.45 (2.78)</td>
<td>-0.54 (1.97)</td>
<td>1.07 (1.39)</td>
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<tr>
<td>CC Employment to Population</td>
<td>0.31 (2.93)</td>
<td>0.42 (2.74)</td>
<td>0.24 (1.99)</td>
<td>0.30 (1.73)</td>
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<tr>
<td>OCC Employment to Population</td>
<td>-0.20 (3.40)</td>
<td>0.05 (0.50)</td>
<td>-0.21 (2.66)</td>
<td>-0.18 (1.51)</td>
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<tr>
<td>CC Per Capita Aid to Average Family Income</td>
<td>0.54 (5.02)</td>
<td>0.76 (4.17)</td>
<td>0.44 (3.65)</td>
<td>0.38 (2.34)</td>
</tr>
<tr>
<td>OCC Per Capita Aid to Average Family Income</td>
<td>-0.60 (5.43)</td>
<td>-0.78 (4.20)</td>
<td>-0.43 (2.82)</td>
<td>-0.31 (1.35)</td>
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<tr>
<td>Constant</td>
<td>-5.77 (1.57)</td>
<td>2.61 (0.63)</td>
<td>-4.33 (1.48)</td>
<td>-10.8 (1.59)</td>
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<tr>
<td>Adjusted R²</td>
<td>0.63</td>
<td>0.45</td>
<td>0.49</td>
<td>0.28</td>
</tr>
<tr>
<td>F Statistic</td>
<td>10.87</td>
<td>5.72</td>
<td>6.43</td>
<td>3.20</td>
</tr>
</tbody>
</table>


Absolute values of t-statistics, number of observations: 35 in all four equations.

*All Variables are in logarithms.

*The dependent variable is the log of the ratio of per capita expenditure in the CC to expenditure per capita in OCC.

*The 1970 regression uses values from 1976 for these two variables.
The estimation results are presented in Table 1 for disparities in non-education expenditures, and in Table 2 for disparities in education expenditures. Both demand control variables — average family income and per capita state and federal aid relative to family income — generally take the expected sign and are statistically significant. The per capita expenditure disparity between the central city and the suburbs increases with the central city’s average family income and state and federal transfers relative to income, and it decreases with the suburbs’ increases in income and aid. The estimated elasticity coefficients are more stable over time for state and federal aid than for average family income. For most years, there is a different response in “education” and “other than education” disparities to differences in income and aid. For example, a 10 percent higher increase in average family income in the central city in 1981 would have led to a 10.5 percent greater disparity of “non-education’ expenditures. In the same year, an identical increase of 10 percent in average family income in the suburbs would have decreased the disparity by 5.4 percent. Identical 10 percent increases in average family income in the central city and the suburbs in 1981 would have led (in our sample) to a 5.1 percent increase in the disparity of non-education expenditures.

The most important results from the perspective of this paper are those for the ratio of employment to population, the proxy variable for the demand for services by non-residents. The “commuting” variable exerts a stable (through time) and statistically significant effect on the disparity in non-educational expenditures but it has no discernible impact on the central disparity in educational expenditures.

Table 2

<table>
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<td>CC Average Family Income</td>
<td>0.67</td>
<td>0.60</td>
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<tr>
<td></td>
<td>(1.67)</td>
<td>(1.66)</td>
<td>(0.89)</td>
<td>(0.88)</td>
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<tr>
<td>OCC Average Family Income</td>
<td>-0.68</td>
<td>-0.77</td>
<td>-0.59</td>
<td>-1.09</td>
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<tr>
<td></td>
<td>(1.64)</td>
<td>(2.36)</td>
<td>(2.43)</td>
<td>(2.57)</td>
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<tr>
<td>CC Employment to Population</td>
<td>-0.01</td>
<td>0.02</td>
<td>-0.06</td>
<td>-0.30</td>
</tr>
<tr>
<td></td>
<td>(0.14)</td>
<td>(0.19)</td>
<td>(0.56)</td>
<td>(0.74)</td>
</tr>
<tr>
<td>OCC Employment to Population</td>
<td>0.02</td>
<td>0.07</td>
<td>0.01</td>
<td>-0.06</td>
</tr>
<tr>
<td></td>
<td>(0.30)</td>
<td>(1.17)</td>
<td>(0.21)</td>
<td>(0.92)</td>
</tr>
<tr>
<td>CC Per Capita Aid to Average Family Income</td>
<td>0.23</td>
<td>0.26</td>
<td>0.30</td>
<td>0.33</td>
</tr>
<tr>
<td></td>
<td>(2.17)</td>
<td>(2.60)</td>
<td>(2.88)</td>
<td>(3.66)</td>
</tr>
<tr>
<td>OCC Per Capita Aid to Average Family Income</td>
<td>-0.43</td>
<td>-0.23</td>
<td>-0.26</td>
<td>-0.14</td>
</tr>
<tr>
<td></td>
<td>(3.92)</td>
<td>(1.99)</td>
<td>(1.92)</td>
<td>(1.11)</td>
</tr>
<tr>
<td>Constant</td>
<td>-0.97</td>
<td>1.57</td>
<td>2.40</td>
<td>7.73</td>
</tr>
<tr>
<td></td>
<td>(0.27)</td>
<td>(0.61)</td>
<td>(0.93)</td>
<td>(2.05)</td>
</tr>
<tr>
<td>Adjusted R²</td>
<td>0.23</td>
<td>0.05</td>
<td>0.16</td>
<td>0.34</td>
</tr>
<tr>
<td>F Statistic</td>
<td>2.75</td>
<td>1.30</td>
<td>2.06</td>
<td>3.87</td>
</tr>
</tbody>
</table>


Absolute values of t-statistics, number of observations: 35 in all four equations.

aAll Variables are in logarithms.
bThe dependent variable is the log of the ratio of per capita expenditure in the CC to expenditure per capita in OCC.
<The 1970 regression uses values from 1976 for these two variables.
The stability of the coefficient on the “commuting” variable over the two decades lends support to our interpretation of it as a proxy for the demand for public services by non-residents. From this, we conclude that the “exploitation” hypothesis is not a viable explanation for metropolitan fiscal disparities. Without additional resources from “selling” some of the non-educational services to non-residents, central cities would have been bankrupt long ago.

CONCLUSIONS AND POLICY IMPLICATIONS

When the financial problems of cities and metropolitan fiscal disparities held the attention of policy makers in the 1970s and early 1980s, there were hopes for reform. Unlike the present situation for some cities, characterized by Dearborn as “out of options,” there seemed to be an optimism about feasible solutions to the problem. Most of these options centered around spreading the wealth either by capturing the suburban tax base to finance urban functions, by receiving a greater share of state and federal government budgets to support urban functions, or by reassignment of important functions (especially redistributive functions) to the state or federal government level. Most of these reforms have not materialized.

Federal Aid

One possibility to resolve the fiscal problems of cities and to redress disparities in fiscal capacity is to increase the flow of federal aid to cities, and to target it on the most distressed places. In fact, this happened for a time with CETA, ARFA, Local Public Works and General Revenue Sharing with a mandated passthrough. But all of the big targeted programs were eventually dropped, and the aggregate flow of federal aid to state and local governments slowed markedly through much of the 1980s. The result of all of this is that the real per capita amount of federal aid to state and local governments is about the same in 1993 as it was in 1972.

The targeting of federal assistance also has changed. There has been no clamoring for a return of the urban aid programs of the mid and late 1970s, and the share of total federal aid going to local governments has declined from a high of 28 percent in 1978 to about 12 percent in 1991. Federal aid to cities was $63 per capita in 1980, but only $30 per capita in 1993 (Pagano, 1993).

State Assistance

State governments are in possession of the most elastic and productive tax bases — income and sales — and are in a position to generate funds to relieve the fiscal problems of cities. This can be done in two ways: direct assumption of responsibility for government functions that weigh heavily in urban budgets, and an increased flow of equalizing state aid.

In fact, the state government share of total state and local government spending rose from 37 percent in 1970 to 40 percent in 1990. The state government share of taxes rose from 55 percent to 60 percent over this same period. However, even though state government budgets were increasing in the 1980s, grants to local governments declined as a share of total state government expenditures. Gold and Ritchie (1993) show that if welfare and education grants are excluded, state aid to local government has grown at a slower rate in each successive year in the 1990s.

Why have states not come to the rescue? A number of reasons might be cited. First, the era since Proposition 13 has been a time of slow growth in state government taxes — a factor often attributed to the anti-government bias of voters. The effective rate of total state and local government taxes in 1990 was 11.4 percent, about the same levels as in 1969. When coupled with reductions in federal aid and new mandates, states simply did not feel that they had the money to fund all activities, and local governments apparently came off as a low priority activity. Instead of stepping in to assist local governments, states borrowed a page from John Shannon’s “Fend for Yourself Federalism” and passed the cuts on to their constituent local governments.

A second reason why states have not assisted local governments to a greater extent than they have, is that the recession hit many states hard. The resulting revenue shortfalls and particularly medical assistance expenditures forced states to near-record level discretionary rate increases in 1991 and 1992. Not surprisingly, states looked to cut their costs by offloading on to their local governments.³

Third, with a changing mix of population, the dominance of suburban representation in state legislatures became even stronger. Fourth, there may be an anti-city bias in some legislation, and sometimes a notion that cities have brought many of these problems on themselves. Even the bailouts of troubled local governments takes more the form of state control than of state subsidies.
TIGHT BUDGETS: CAN CITIES PICK UP THE BURDEN?

Metropolitan Government

The expansion of city boundaries to include the wealthier suburbs has always been seen as one solution to the city fiscal problem. At one time, this would eliminate intergovernmental fiscal disparities and would increase the financial capacity of the cities. But precious little consolidation or metropolitan governance occurred in the 1980s. Why so little consolidation? The reasons are clear. The more affluent suburban residents are loathe to take on the dreadful problems confronting cities, and are convinced that they can escape these problems through physical separation. Moreover, black leadership in the cities is loathe to give up the political gains they have made — as metropolitan government would surely require. In short, there is not a constituency for metropolitan government.

Regional Tax Base Sharing

Cities could strengthen their positions dramatically by taxing their entire region rather than just their own base. This might be done in a number of ways. Commuters could be taxed either explicitly or through local sales and payroll taxes, or tax bases could be shared between cities and suburbs.

The Minneapolis, St. Paul tax base sharing scheme is an example that was spotlighted perhaps as much as any local tax scheme, but it was not imitated to any significant extent. Many cities have enacted sales and payroll taxes and commuter taxes, and these served them reasonably well in the 1980s. In fact, however, local governments have come to rely even more heavily on the local property tax in recent years. This raises some especially worrisome problems for cities because declining property values will eventually erode the tax base (Petersen and Edwards, 1993)

Gentrification

In the late 1970s, planners saw a rebirth of cities as centers of residential, commercial and cultural activity. In fact, however, gentrification never occurred on any scale that would offset the declines that were going on elsewhere in the city, and much of the new construction was off the tax roll.

School Finance

Many believed that they key to the disparities issue was with the courts and the school finance cases. The basis of this argument was that per student property wealth varied widely across school districts, hence property tax financing of public schools did not provide all students with access to an equal quality education. However, the court actions that would have redressed these imbalances flagged during the 1980s.

Conclusion

Neither the financial conditions of the most distressed cities, nor the fiscal disparities between cities and suburbs improved during the last decade. If anything, the situation worsened because these places missed out on the economic gains from the 1980s. Tax burdens remain higher in central cities, and per capita expenditures for education are lower. Those cities on the “distressed” lists in the 1970s remain there in the 1990s, and in some cases they appear to be out of options. Policy at the federal and state levels has failed American cities. The federal government has pulled back in its dispersal of assistance to local governments, states have done likewise, and local governments have resorted more heavily to the property tax to make up the shortfalls. For political and economic reasons, various forms of metropolitan governance have not caught on, nor has a meaningful program of regional tax base sharing. There are no strong automatic forces that will cause a new equilibrium, free of disparities, to occur. In the absence of government policy, these fiscal disparities and the weakening of the financial condition of the distressed cities, will likely continue.

The policy options open to deal with the urban fiscal issue are limited. Given the fiscal condition of the federal government and the paucity of new urban initiatives on the drawing boards, large amounts of new, targeted federal aid would not appear to be a likely alternative. The responsibility more likely will be shifted to the states, in three areas: initiatives to promote regional taxation, increases in targeted assistance to local governments, facilitation of regional governance solutions, and direct assumption of responsibility for certain social services. All of these will require increased revenue mobilization by state governments.
ENDNOTES

1. The 35 cities were included in the set of 37 cities used in the earlier ACIR study of fiscal disparities. A common (1984) definition of the MSA has been used. Two cities (Patterson, New Jersey, and San Bernadino, California) are omitted because of missing data.

2. State and federal aid are at least to some extent determined by the level of expenditures in the jurisdiction. This simultaneous determination of aid and jurisdiction expenditures would require the use of a two-stage least squares estimation procedure. When the equations were estimated using TSLS, the results were very similar to those obtained under OLS. Consequently, only the OLS results are reported here.


REFERENCES


