

The Impact of State Government Fiscal Crises on Vertical Fiscal Competition Between States and Local Governments

Howard Chernick, Hunter College, City University of New York

Andrew Reschovsky, Robert M. La Follette School of Public Affairs, University of Wisconsin

In attempting to balance their budgets, state governments around the country have been reducing fiscal assistance (grants-in-aid) to their local governments. The ability of local governments to continue current levels of public service delivery in light of these cuts in aid depends in large part on their ability to replace intergovernmental revenues with additional own-source revenues.

States and local governments in the United States typically rely on different tax instruments to finance their spending requirements. For local governments, the property tax is the main revenue source, while for states the most important taxes are the personal income tax and general and selective sales taxes. In a number of states, local governments, particularly large cities, have attempted to diversify their tax portfolios by adding local option general sales taxes and selective sales taxes. In a small number of cities, local income taxes are also used. It is important to recognize however that the power of local governments to tax is closely controlled by state governments. The constitutional position of local government is one of subservience, as they are the legal creatures of the state.

State governments which allow their local governments to diversify their tax instruments are implicitly inviting more direct competition with their own fiscal powers, as with diversification they are more likely to share a common tax base. An increase in local tax rates, may, by invading the state base, reduce state's revenue raising ability, and a similar affect applies in terms of state rate affects on local taxing ability. An example of a "revenue sharing" solution to this joint tax problem is provided by the cigarette tax in New York City. As the price for giving New York permission to raise its cigarette tax from 8 cents to \$1.50 per pack in 2002, the city was forced to send 46 percent of any revenue increase to the state.

In this paper, we will study the impact of the state government fiscal crisis on the vertical tax competition between states and their large cities. We plan to explore several related questions. Did states that allow diversified local government revenues, reduce intergovernmental aid by greater amounts than non-diversified states? To what extent are taxes at the two levels of government substitutive, versus complementary? Have cities with more diversified tax revenue bases been able to weather the economic downturn and maintain public service delivery more successfully than cities that rely on the property tax for most of their local tax revenue?

To conduct our study, we will draw on institutional data on tax sharing arrangements for selected large cities, data on state and local tax rates from the Citizens for Tax Justice, and detailed data on tax and intergovernmental revenues from the Census Bureau.