The Do's and Don'ts of City Finances

Cities need to get their financial house in order.

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IF WE HAVE learned anything about the fundamental determinants of real estate values over the past fifty years, it is the importance of man-made environments for overall asset returns. The shelter benefits of real estate are relatively easy to replicate. A warehouse is a warehouse, an office is an office, a gourmet kitchen is a gourmet kitchen. Easy replication means lots of competition and at best a competitive rate of return. The benefits of attractive natural environments—warm weather, ocean fronts, and mountain views—will exceed the competitive return, but only for the first owner. Subsequent owners will pay for nature's gifts in a higher price of land;

there are no additional entrepreneurial profits here.

In today's economy, higher than competitive returns are most likely to be found in attractive environments. Residential neighborhoods that provide clean streets, personal and property safety and, perhaps most important, high-quality schools earn significant premiums over less attractive neighborhoods. Workplaces that provide needed infrastructure, safety and ready access to colleagues and clients also earn higher than competitive market returns. An important partner in providing these attractive locations is government—in particular, city governments. Real estate values rise when cities provide better services for the same tax rates or the same services for lower tax rates. Improving government performance is a key to higher real estate returns. To this end, one needs to understand the Do's and Don'ts of city finances and to then turn the Don'ts into the Do's.

THE DO'S OF CITY FINANCE

Efficient city finances provide residents and firms with the services they want at the lowest cost. The following five Do's provide the institutional setting needed for efficient, and therefore value maximizing, city government.

1. *Tax Them Where They Live.* The ideal tax system for economic efficiency is one that matches each family's or firm's payments to the services they receive. This is what an efficient market does, and it is what an efficient city government should do as well. Since residents and firms receive city services where they live, then taxing them where they live is efficient. User fees are the first of the efficient taxes. The level of the fee should equal the long-run marginal cost of providing an extra level of public services. If the most efficient way to provide a service is by a neighborhood or perhaps the whole city, the efficient fee would be the marginal costs of providing the whole group—say, picking up the trash on Wednesday—shared among all members in the group in proportion to services received. When user fees are not administratively possible, the next best tax would be residential property taxes for residential services, and business taxes on land values for business services. Do not tax business capital. Often called a "two-rate" system of property taxation, the recommended tax separately taxes residential and business properties so as to better match taxes paid to differential levels of services received. In administering the property tax, assessed property values must accurately reflect market

value. Techniques are now available for such market-based assessments. There is no excuse for poor property tax administration.

2. *Pay Competitive Wages and Hire for Value.* Managing labor costs is job one. Labor costs consume 60 percent to 70 percent of city spending. Valued city workers should only be compensated commensurate with their next best employment opportunity, which means higher compensation for more skilled workers. Cities can learn appropriate compensation by posting the wage and job requirements, interviewing candidates, and selecting (perhaps after training and a trial period) the most preferred candidates. If the pool of acceptable workers is less than needed, then employee compensation should be increased.

   Just as a private firm hires workers for value, so too should the efficient city. Firms hire workers as long as the extra revenues the workers bring to the firm exceeds their compensation. Rather than extra revenues, the value of the city worker is the extra benefits that worker's effort provides to taxpaying residents and firms. But how to measure these benefits? At a minimum, connect additional workers to quantifiable additional service outcomes: more trash collected and potholes filled, lower neighborhood crime rates, faster response time to fires, better student performance on standardized math and reading tests. But such outcome measures are not enough. We also need to know by how much citizens and firms value these outcomes. While the marketplace provides this valuation by market prices, most city services are not for sale. How then might we discover how much a citizen values a service outcome? I offer one strategy below: provide choice.

3. *Balance the Current Accounts Budget.* The costs of providing city services in any budget year should be fully covered by that year's fees and taxes. As required by generally accepted accounting principles (GAAP), costs should include all economically relevant expenses: labor costs including the full funding of public employee pensions, costs of materials, and depreciation in the use of city infrastructure. While worker wages, health care premiums, and materials costs all come as weekly, monthly, or annual bills that must be paid, public employee pension contributions and infrastructure maintenance can be postponed without notice. Failure to fund pensions or maintain infrastructure saves money for current taxpayers, thus the temptation, but the long-term consequences can be disastrous. The collapse of the bridge between

St. Paul and Minneapolis in 2007, which cost thirteen lives, and the current $2 trillion public pension deficit, which threatens the fiscal solvency of many states and cities, are two recent painful examples. In both cases, taxes will need to rise. The message is the same as the mechanic's warning in the old TV commercial for motor oil: "Pay me now, or pay me later." Cities with decaying infrastructures and such large unfunded liabilities are less attractive to future residents and firms, with obvious negative effects on city real estate values.

4. *Provide Redistributive Services Locally, but Fund "Globally."* Lower-income families live in cities because that is where the older, low-cost housing stock is typically available. This fact has important fiscal consequences. First, providing city services to a population that includes a significant share of lower-income families may raise the cost of those services, for example, if lower-income children come less well prepared for public education or if lower-income neighborhoods are less well maintained. Second, because of state and federal mandates for health care, housing, welfare payments, and foster care, cities are administratively responsible for public assistance to lower-income families. To the extent that cities know the needs of lower-income families and neighborhoods, this makes sense. For example, teachers know the children who are not getting a full breakfast, and police officers on the beat know which households involve abuse. However, cities must not be asked to pay the costs of poverty. If they pay these costs, then middle-class families and successful businesses may then leave an otherwise desirable city, as they no longer receive a competitive bundle of public services for the taxes that they pay. The correct strategy is to provide poverty services locally, but (and it's a very important "but") share the fiscal burden widely.

5. *Offer Choice.* Offering choice to residents and firms in the provision of city services yields two important benefits. First, choice provides discipline. If one city government is inefficient, then firms and households can relocate to a more efficient provider. Simply knowing that another government is more efficient, current residents and employers have the example they need to encourage greater efficiency in their own city. Second, choice allows firms and citizens to shop across locations for the right levels of services and taxes. Their choices then reveal the value they place on city services. Choice means both greater production efficiency and a better match of city services to the demands of residents and firms.

How can cities best provide choice? In three ways. First, recognize the benefits for city residents of a competitive network of suburban governments. Having a range of well-run suburban alternatives provides city officials with just the reason—some might say, excuse—they need to make tough budgetary choices. Second, within the city, provide choice to firms through business improvement districts (BIDs) and to residents through neighborhood improvement districts (NIDs). BIDs and NIDs can efficiently provide city services where service economies are modest, say where 10,000 to 20,000 residents allow full economic efficiency. We know from the experience of well-run suburbs that K-12 education, police patrols, fire protection, trash pick-up, local street maintenance, libraries, and recreation centers can all be done efficiently by small governments. A large city can then provide those services where economies of scale are important: higher education, investigative services, courts, trash disposal, maintenance of infrastructure, and central research libraries. Financing can be done by a two-tier tax system with a base rate paying for city-wide services and a supplemental rate chosen by businesses and residents for their BID- and NID-provided services. The city's base rate can also finance redistribution between neighborhoods to ensure a basic standard of core city services. Third, promote transparency in governance and open access to city-wide political office. Together, local economic choice complements city-wide political choice. Much like governorships test the mettle of future presidents, so too can managing a BID or NID be the testing ground for future city mayors.

THE DON'TS OF CITY FINANCE

For each Do there is a matching Don't, often implemented with the best of intentions but generally leading to inefficient city finances and therefore value-reducing consequences for city real estate. Here is the list of city fiscal policies Don'ts.

1. *Don't Tax Them Where They Work.* Inputs used in production by city firms should not be taxed. Both labor and capital within the city have opportunities to work elsewhere. Thus any city tax on these mobile inputs will require a compensating increase in wages or returns if they are to continue to work for city firms. What taxes qualify? A tax on non-resident employees' wages—a commuter income tax—is tax on mobile city labor. A property tax on the value of firm equipment and firm

structures is a tax on mobile city capital. Because of this "backward shifting" of city taxation onto to firm costs, profits of city firms decline, and firms leave the city. A fall in city real estate values is the final consequence. My recent research with colleagues consistently finds significant adverse effects of commuter taxes on city employment in Philadelphia and New York City and significant negative effects of property taxation on investment and ultimately real estate values in Philadelphia, New York City, Minneapolis, and Houston. The effects can be sizeable. The Philadelphia commuter tax has cost the city more than 100,000 jobs over the past forty years. For a 10 percent increase in city property tax rates, say from 2.0 percent to 2.2 percent, we estimate that real estate values will fall by 1.9 percent in Minneapolis, 4.3 percent in Philadelphia, 7.5 percent in New York City, and 10 percent in Houston.

Why would a city adopt taxation of mobile factors if these taxes cause such damage to the city's private economy? Two reasons: one valid, one not. The valid reason is that mobile factors, particularly mobile labor, do use city services when they locate in the city. Commuters should contribute to the costs they impose on city budgets for the use of city roads and city protection services. But rather than a general tax on commuter wages, the city should use targeted taxes and fees. Tolls for entry into the city for drivers—much like the London congestion toll—or taxes on city garage parking during peak work times are alternatives. Commuters using public transit can be charged a fee above marginal-cost transit fares. The invalid reason is political. Mobile labor and capital from outside the city, and the firms that hire them, do not vote. For city officials then, factor taxation may look like "free money." Free, that is, until firms leave the city or reduce their city work force and real estate values fall. Together, the Do and Don't for city taxation reduces to a simple dictum: Tax it where it lives, not where it works.

2. *Don't Grant Unions Monopoly Status:* Public employees should be given the right, following fair elections, to organize and to collectively bargain for the terms of compensation and employment, but not the right to be the monopoly supplier of labor services to city residents. The later occurs when state bargaining law extends beyond a union's traditional right to "meet and confer" to "duty to bargain." State duty-to-bargain regulations require city employees to be members of the union and for employee compensation and the terms of employment to be decided

only through labor negotiations. In effect, in duty-to-bargain states, cities face a monopoly supplier of public employees. Like any monopolist, public employee unions then act to raise the prices paid for their services. The effect is to significantly increase public employee wages by from 10 percent to 15 percent over the wage earned by comparably skilled workers in the private sector or in meet-and-confer states. And because unions in duty-to-bargain states must approve all new hiring and firing, there are often inefficiently too many public employees. Negotiated work rules both protect existing jobs and block any efforts by the city to contract out services to more efficient private providers. Rules meant to introduce a balance of power into a once-abusive labor environment have, in duty-to-bargain states, overshot the mark. The inevitable consequence is high costs for city services.

3. *Don't Borrow for Current Services.* It is tempting for elected officials to borrow from the future for the provision of city services, and there are many ways to do so. Accounting gimmicks can be used to hide excesses. Prior to GAAP, New York City called janitors "capital maintenance workers" and paid their salaries from bond proceeds. Bad budgeting is another strategy. For example, underestimate the costs for snow removal, but then when the usual snows come, use short-term debt rolled into next year's budget to fund the needed service. Then there is neglect. City infrastructure decays in ways different from machines. Rather than slowly grinding to a halt, bridges, tunnels, sewers, and roadways continue to provide service but then just collapse. City officials can therefore avoid required maintenance and hope the disaster happens on the next mayor's watch. Underfunded defined benefit pension plans provide another way to de facto borrow from the future. Employees work for a promised wage and pension. To meet these pension promises, cities must contribute an actuarially estimated annual full funding contribution, called the pension's normal cost. Failure to do so creates a shortfall that must be filled by future contributions. Today's level of underfunding has been estimated to be $2 trillion for all state and local pensions.

As a corollary, here is another Don't: Don't rely on state balanced budget requirements or state supervision of local pensions to protect the fiscal integrity of city current account budgets. It is true there are rules, but these requirements are often badly written or weakly enforced. The only balanced budget requirements that work are those that require balance at

the end of each fiscal year. Many states require only a projected balanced budget at the beginning of each fiscal year, not an actual balance at year's end. And even with an end-of-year requirement, what do states do if the city violates the requirement? More often than not, it is simply "Please don't do it again." Pension funding, too, is only weakly monitored. Actuarial calculations of the pension contributions needed for full funding require a variety of assumptions about future wage growth, future rates of return, and future rates of pension vesting and retirement. Are those assumptions reasonable? The math is always right, but as we have now discovered in hindsight from the current crisis, actuarial assumptions have been overly optimistic.

4. *Don't Underfund Poverty Mandates:* State or federal mandates do make sense if local governments are the efficient providers of redistributive services. If lower-income households are a political minority in their cities, then redistributive services that do not directly benefit city firms and middle-class families will typically be the first cut in hard times and the last funded in good times, an outcome economists call the "race to the bottom." This occurs even though all middle-class families might prefer to provide such services, but only if all cities and states do so in unison. One solution to this problem is to set national or state-wide minimum standards for redistributive services. But standards alone are not enough. Since cities are the typical home for lower-income households, unfunded mandates will impose a large fiscal cost in high-poverty cities. This extra fiscal burden leads to higher taxes or lower services for the non-poor, both of which encourage those taxpayers to leave an otherwise productive and attractive city. This is inefficient. The complete solution to the concentration of poverty in our cities is to be sure all state and national mandates are fully funded.
5. *Don't Consolidate.* If a region's central city is doing a poor job of managing its finances, perhaps because of the four Don'ts above, the temptation may be to scrap city governance altogether and turn to a regional government as the answer. Regional governments have a role to play in providing public services, but it should be a targeted intervention, used only where intergovernmental cooperation is required for economic efficiency. There are two settings where this is true. First, where economies of scale in the production of city services are very large—for example, for waste disposal, ports and airports, prisons, higher education,

and sports stadiums. Second, where coordination of service provision is important—for example, in public transit, water treatment, air quality, and major roadways. But for all other city services, competitive smaller governments can do the job efficiently, and provide the important advantages of choice for firms and families. The only reason to have a monopoly in public service provision (and that is what a regional government becomes) is to reap the advantages of economies of scale and government cooperation. Unless those advantages are sizeable (and not captured by union workers), don't consolidate.

THE NEXT STEP

If the fiscal Do's enhance and the Don'ts discourage good city fiscal performance, and good performance leads to better city environments and thus higher real estate values, how then can we turn Don'ts into Do's? The first step is to measure the adverse effects of the Don'ts on city finances and city real estate values. The next step is to then use that information to build a political coalition for reform. Two recent reforms from Philadelphia are instructive.

First, from 1969 to 1985 Philadelphia more than doubled the tax rate on commuters' wages, increasing the rate from 2.0 percent to 4.31 percent. Since this tax was shifted back onto business profits, increases in the rate had adverse effects on city jobs. In 1989, I estimated that approximately half of the 250,000 jobs lost to the city's economy between 1970 and 1986 could be attributed to the rising commuter tax rate. The other half of the job loss was due to events outside the city's direct control: the world-wide decline in demand for manufacturing and the U.S. flow in jobs from the Northeast and North Central regions to the South and to overseas.

By the beginning of fiscal year 1991, these high tax rates, combined with expensive labor contracts (Don't Number 2) and six years of deficit spending (Don't Number 3), pushed Philadelphia to the edge of bankruptcy. In that year, the structural deficit was $210 million for a budget of $1.3 billion. With a freeze on city tax rates and three years of labor cost containment, however, the city's economy recovered and the budget returned to balance, and by 1995 the city had a $200 million surplus. Heeding the lessons of the past, Mayor Ed Rendell allocated a significant share of all future years' surpluses to future reductions in the city's wage tax and other business taxes. Today the commuter wage tax rate is 3.7 percent. I have estimated that this reduction in wage tax rates has returned 30,000 jobs to the city's economy. This

confirmation of good fiscal policy has left its impression on city residents. The next two mayors, with the support of city businesses and even residents from the lower-income neighborhoods, have maintained a commitment to lower business taxation.

Second, Philadelphia as a city-county bears full responsibility for funding the city's share of state poverty mandates. This is in contrast to Pittsburgh where city poverty expenses are shared with wealthier suburban governments in the larger Allegheny County. I have examined the potential benefits of a similar arrangement for Philadelphia. Using an economic model that connects city fiscal policies to city and suburban real estate values, I estimate that sharing the costs of Philadelphia's mandated poverty services with its four surrounding suburban counties has the potential to increase real estate values in the city—that is no surprise—and, if done appropriately, in the suburbs too. If the city's savings from more fully funded poverty mandates is required to be spent to lower business taxes, then city real estate values will rise by 2.1 percent and suburban values by 1.8 percent, even though the average suburban family will be contributing a modest $150 annually for city poverty. For a typical suburban family, the value of this reform is an after-tax, net present value increase in home values of about $2,800. This reform promises to be a win-win.

Where is the rabbit in this hat? It comes from the fact that a stronger city economy attracts businesses and residents into the entire metropolitan area and that this stronger demand for suburban locations more than offsets the negative effect of increased suburban taxation. Philadelphia's suburbs, particularly the inner-ring suburbs most likely to benefit from stronger city growth, now recognize this fact and have begun to work with Philadelphia to rationalize regional public finances through coordinated efforts for reform at the state level.