

Urban Finance Under Siege

Thomas R. Swartz
Frank J. Bonello

Editors

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Preface

The responsibility to provide basic government services—elementary and secondary education, public safety, streets and highways, public assistance, general government—has experienced several dramatic reversals over the past forty years. In the immediate post–World War II period, local governments were nearly totally responsible for these expenditures, which they supported with revenues from the then powerful property tax. However, as society became increasingly aware of the disparities in the fiscal capacity of local governments, fiscal responsibility was “assumed” by higher levels of government: state and federal government.

The process of leveling the playing field for local governments continued through most of the 1960s and 1970s. By the end of the 1970s, however, public policy once again experienced a reversal. We entered the age of devolution, in which local governments were expected to pay their own way. A libertarian-like philosophy of government developed, which demanded that individuals take responsibility for their own actions or inactions and also expected local governments to fend for themselves.

Unfortunately, the once dominant property tax had become a slender profile of its former self. Over time its tax base had been systematically eroded to make way for green space, public buildings, new streets and expressways, and innumerable other tax-exempt activities. More recently, this same tax base has suffered yet another direct assault: the sharp decline in residential and

commercial values that has occurred in many communities, particularly on our coasts.

Thus at the very moment that higher levels of government mandate that local governments take fiscal responsibility for the provision of basic government services, the revenue capacity of their principal tax is called into question. How narrow is the property tax base? Will the decline in residential and commercial property values translate into a sharp drop in assessed value in the foreseeable future? What are the other sources of revenue that local governments can turn to in their efforts to underwrite the costs of their new expenditure obligations? As we approach the twenty-first century, can we legitimately expect local governments, particularly those that are fiscally stressed, to overcome somehow the deep-seated national malaise that is associated with our loss of stature in the world economy? Or, alternatively, have the electronic and print media and some professional urbanologists overstated the problems faced by urban America?

These and many other related questions are considered in the essays that follow. Five of the nation's most respected scholars of local government finance visited us here at Notre Dame to examine the root causes of fiscal stress endured by many U.S. cities, the effectiveness of the policy instruments that have been fashioned to address the plight of urban areas, and the prognosis for the future. The willingness of our participants to reorder their priorities to make room for this project on their over-committed calendars testifies to the urgency of the problems confronted by U.S. cities, large and small. If we as a society are to remain a real presence in the modern-day world, we cannot ignore the warning signs found in the pages that follow. We cannot afford a policy of benign neglect.

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T. R. Swartz
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Urban Finance Under Siege

1

Rethinking Urban Finance in America

THOMAS R. SWARTZ

The New Urban Poverty

We are quick to believe that the problems we face as a society are the worst problems our society has ever faced. For the poor trapped in many of our cities, this may be true. These cities are plagued by unemployment rates, particularly among African-Americans, Hispanics, and teenagers, that rival the experiences of the 1930s; a decaying stock of affordable houses that has not been systematically replenished by public housing authorities; an education system that “fails” those who are most in need of its benefits; and infrastructure that has been left to crumble because funds are needed to plug gaping holes in municipal budgets rather than holes in water mains, sewer lines, or, as in the case of Chicago, an abandoned underground access system. Unfortunately, this short list of problems fails to capture the real poverty of urban poverty: the fatalism of urban gangs; the explosion of teenage pregnancies; the devastating effects of crack, coke, and alcohol; the horror of AIDS as it spreads unabated; and the sense of isolation and rejection as the affluent, mostly suburban community turns its back on those who are inescapably caught in this whirlpool of decline.

The Old Urban Poverty

The horror faced by today’s urban poor, however, obscures the fact that cities have always been harsh places to live if you were

poor. Capture in your mind's eye a picture of the city at the turn of the century. There were unpaved or crudely paved streets crowded with traffic—a mixture of horse-drawn wagons and primitive gas-powered cars and trucks, each emitting its own pollution, the former biodegradable perhaps but nevertheless an unpleasant pollutant. Raw sewage flowed in open gutters downhill toward bodies of water that often represented the city's transportation system and only source of potable water. Heavy black smoke hung low in the sky, as both homes and factories were fueled by coal. Cities were loud, dirty, crude, unsafe, eerie, and unpredictable, particularly if you wandered into the areas where the poorest of the poor lived in tenements and other makeshift homes.

If you had money, however, you didn't have to endure the hardships of the city. At least you didn't have to live in the midst of those problems, even if you had to spend your workdays there. You could move to the end of the trolley line. You could move to a converted farmhouse on the edge of the city. Or you could move to the top of "Knob Hill" and get above the pollution while your wastewater ran downhill to those less fortunate than you. In brief, if you had the wherewithal you could separate yourself from the problems of the city. In days gone by, just as today, you could economically isolate yourself from an undesirable situation—you could buy your way out.

The Tiebout Effect

The motivation to flee things that we find to be "undesirable" is rooted in economics and was first discussed by Charles Tiebout (Tiebout 1956). We respond to what we perceive to be negative externalities or negative spillover effects from our neighbors. Although we try to control the actions of our neighbors both within the law with local ordinances or zoning restrictions and federal or state statutes, and outside the law with intimidation and social pressure, sometimes this simply does not work. That is, third parties over whom we have no control can directly and signifi-

cantly affect us. If my neighbor lets her house fall into disrepair, the value of her property falls, but in addition I pay part of the cost of her decision or lack of action: the value of my house falls. If I am surrounded by negative externalities—houses in disrepair, congested streets, drug dealers, prostitutes, dirty book stores, rats in the alleyways—in an effort to minimize my loss I may be forced to move.

There are two obvious implications of this. First, not everyone has the luxury of fleeing negative externalities. The aged may be too deeply rooted in their neighborhoods or too dependent upon urban public and private services to pick up and escape, while the poor simply do not have the wherewithal to move. Mobility is a privilege, therefore, that the market reserves for a few: primarily the affluent members of society.

The second implication is less obvious and ultimately more devastating for urban finance. It concerns the terminus of the moves. If our mobile affluent move within the civil boundaries of the city, the municipal tax authority still has access to their taxpaying capacity; if our affluent move beyond the civil boundaries, however, it becomes much more difficult for the city to claw-back tax revenue from them even though these individuals may still work within the city and continue to benefit from the multitude of services provided by the city. In the words of the late Father Geno Baroni—a community activist of the 1960s and 1970s—if we don't stop the outmigration of the rich from the city proper, "cities will become *black, brown, and broke*."

The Problem Begins

That is exactly what began to happen in the mid 1950s. Prior to that time, when the affluent moved away from what they found to be negative externalities, they remained in the city. Sometime in the 1950s this pattern changed. Those who moved to avoid negative externalities, moved outside of the taxing authority of the city. They moved to suburbia. As Katharine Lyall explains in the next chapter of this book, this outmigration has potentially devastating effects for our cities.

Because of these changing demographics, the very character of our cities changed in the 1950s and 1960s. In the presence of great wealth, large, rapidly growing pockets of urban poverty began to appear. In addition to rural poverty, America now had urban poverty that was spreading at an alarming rate. City after city, particularly in the Northeast Corridor and in the Great Lakes Region, began to experience fiscal stress as the young and the affluent fled to the suburban rings that encircled our cities. As fewer and fewer wealthy taxpayers were forced to support the ongoing expenses of the city, urban tax rates had to rise. As tax differentials between cities and the suburban rings that surrounded them grew, more affluent families were pulled away from their urban roots.

Other wealthy urbanites were pushed out of cities. These were families in search of superior public goods and services: good schools, safe streets, green parks, less congestion, and so on. That is, as the composition of the urban population changed and poor people became a larger percentage of the total population, the tax base narrowed. (See Dick Netzer's discussion of this in chapter 3.) City officials believed they had little choice but to eliminate public spending on luxury items: parks, zoos, libraries, special education programs for the gifted, summer recreation and crafts programs, improvements in golf courses and swimming pools. These "frills" were replaced by increased expenditures on the urban safety net that had to protect an increasing number of families from abject poverty.

The consequence is obvious. Since the wealthy had to pay a higher tax price for a bundle of public goods and services that they had little or no use for—public housing, food stamps and Medicaid, general welfare, public defenders—in the words of Charles Tiebout, they "voted with their feet." They did exactly what economists would expect: they sought out and found a bundle of public goods and services that fit their needs at a tax price they were willing to pay. These were the goods and services provided by suburban communities.

Unfortunately, this problem was not self-correcting. Indeed, in

the short term the prognosis was grim. As more and more of our rich left the city, they took with them their taxpaying power and their positive externalities. They left behind a community with an eroding tax base and a growing expenditure need. In recognition of this, federal and state governments stepped in to halt the downward spiral.

Leveling the Playing Field

Federal grants-in-aid to state and local governments increased sharply.¹ In the 1950s, federal support represented little more than 10 percent of state and local government spending. Throughout the 1960s and most of the 1970s these grants steadily rose, as public policy explicitly attempted to level the playing field for state and local governments. Indeed, federal programs designed to impact directly impoverished areas sprouted like mushrooms after a rainstorm. Kennedy's New Frontier, Johnson's Great Society, and Nixon's New Federalism gave us Medicare/Medicaid, the Economic Opportunity Act, Community Development Block Grants, General Revenue Sharing, Urban Development Action grants, the Comprehensive Employment and Training Act, Titles I and II of the Elementary and Secondary Education Act, the Economic Development Administration—the list goes on and on. By 1978, the peak year for federal support of lower levels of governments, federal grants supported 25.3 percent of state and local spending.

Competitive Federalism

As Table 1.1 suggests, these lower levels of government were in for a rude awakening. Beginning with the Carter administration, then pursued with a vengeance by the Reagan and Bush administrations, the federal government changed policy direction. Instead of reducing the apparent differences among cities and among states, the new policy heightened them. This was the age of “competitive federalism,” in which the laws of the market were