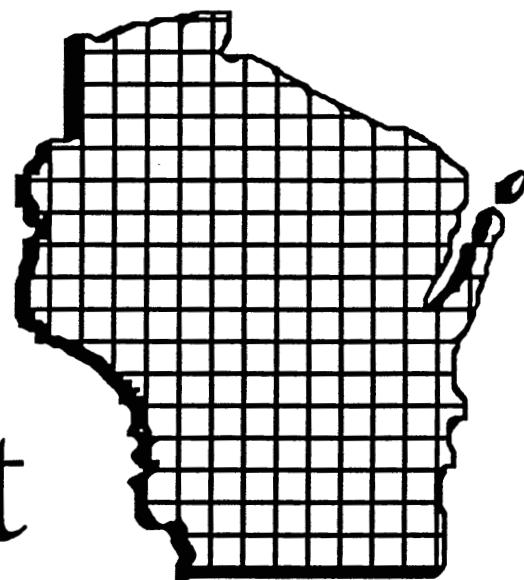


Wisconsin

Policy
Research
Institute
Report



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LOCAL TAXES, SPENDING
AND
PUBLIC ACCOUNTABILITY:
HOW WISCONSIN COMPARES

Report from the Executive Director:

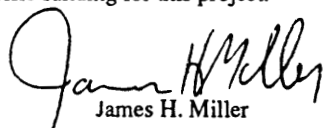
In 1988 the Board of the Wisconsin Policy Research Institute approved a project to do a major study on the question of property taxes in Wisconsin and more to the point on how they were being affected by local spending and state policies. The object of the study was to examine what Wisconsin did in terms of local taxes and spending compared to other neighboring states and the rest of the country. Later that year the Joyce Foundation, located in Chicago, agreed to provide total support for this project. Their support was based on their decision to award funding to several public policy institutes for various subjects dealing with the whole question of state and local budgets. Besides our Institute the La Follette Institute at the University of Wisconsin-Madison was the only other Wisconsin institution to receive funding from the Joyce Foundation.

To do this project we were able to employ two of the leading researchers in the country in the area of local public policy. Dr. Ronald Oakerson had been a senior researcher at the respected research group, the Advisory Commission on Intergovernmental Relations, and had done several similar studies in other states. The second researcher is Dr. Roger Parks, the Director of the Center for Policy and Public Management at the School of Public Environmental Affairs at Indiana University, who has a national reputation in public policy and is an expert in the area of local taxation and spending.

Their report has covered a five-year period in Wisconsin and includes comparative data from neighboring states as well as national averages. The tone of the report indicates the complexities in dealing with the whole question of taxes and local spending. Dr. Parks and Dr. Oakerson point out that there are no simple answers to how one improves accountability of our property taxes. They also examine the states of California and Massachusetts and point out that their dramatic cuts in property taxes are not necessarily the solutions one would recommend for other states; in some instances, these policies have led to some serious problems affecting the delivery of services by government.

What is clear from this report is that local property taxes in Wisconsin are rising because of rapid increases in local educational spending. These increases are fueled by current policies in Madison that reward school districts who spend and penalize school districts who don't by constructing aid formulas that encourage spending. What Dr. Parks and Dr. Oakerson are calling for is a restructuring of Wisconsin's system that brings far more accountability into this whole question of taxes and spending. The idea of somehow switching bases from property taxes to a sales or income tax ignores the real cause of the problem, which is rapidly expanded spending. The best kind of public policy is to lower or stabilize taxes by stabilizing local spending. Dr. Parks and Dr. Oakerson are saying that in Wisconsin we must make the whole system more accountable to the public. All tax money in Wisconsin comes from the same pot, which is Wisconsin taxpayers. To switch taxes from local property taxes to state income taxes or a sales tax does not solve the problem unless there are limits put on local spending.

We again acknowledge support of the Joyce Foundation which gave us specific funding for this project.


James H. Miller

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LOCAL TAXES, SPENDING, AND PUBLIC ACCOUNTABILITY: HOW WISCONSIN COMPARES

by

**Dr. Roger Parks
and
Dr. Ronald Oakerson**

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**LOCAL TAXES, SPENDING,
AND
PUBLIC ACCOUNTABILITY:
HOW WISCONSIN COMPARES**

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LOCAL TAXES, SPENDING, AND PUBLIC ACCOUNTABILITY: HOW WISCONSIN COMPARES

EXECUTIVE SUMMARY

Throughout the 1980s and into 1990, Wisconsin has labored over the twin issues of property tax relief and the control of state/local spending. The two concerns are interrelated, but differently focused. Effective property tax relief requires local tax restraint; otherwise tax dollars spent for relief may instead finance increases in local budgets. Yet, concern over high property taxes leads to efforts to shift the tax burden away from property taxpayers, while concern over high levels of spending leads to broader efforts aimed at controlling or reducing taxing and spending overall. Although Wisconsin is not alone in these concerns--indeed fiscal issues have been the leading state/local concern of the last two decades--Wisconsin's experience is, nevertheless, unique, and therefore needs to be understood in its own terms as well as comparatively.

Having made a commitment to local tax-base equalization, alongside a strong desire for productive local governments, Wisconsin finds itself paying a high tax-price for local goods and services, relative to income, while searching repeatedly for property tax relief. Responding to high property taxes, state legislators increase shared revenues and state aids, which in turn stimulate local spending, which in turn generate upward pressures on property taxes. The process is one that feeds on itself. To get out of this self-perpetuating cycle, Wisconsin must rethink its basic fiscal institutions, including both local tax and expenditure rules and the structure of state aid formulas.

Wisconsin's Recent Fiscal Experience

Wisconsin spends well above the national average for public services. In the early 1960s spending in Wisconsin took a significant jump, and through the 1970s and 1980s, Wisconsin's per capita state and local government expenditures placed Wisconsin in the top half and, more recently, in the top one-fourth of the 50 states. Among its neighbors, Wisconsin's per capita spending for public services has tracked slightly below that of Michigan, significantly below Minnesota's, but well above spending in Illinois or Iowa. Yet, Wisconsin is not a wealthy state. Its state and local spending as a percent of statewide personal income ranks it even higher among the fifty states. By this measure, Wisconsin has generally exceeded all of its neighbors except Minnesota.

During the 1980s, Wisconsin successfully moderated its growth in combined state/local spending, but failed to control property taxes. Real per capita spending by the state and its local governments leveled off in 1986 and remained approximately constant through 1988 and, during 1984-88, declined as a percent of personal income. As a result, Wisconsin has moved much closer to national averages by both measures in 1988. Local property tax relief has proved considerably more elusive, however. In most other states real property tax revenues declined relative to other revenue sources over the last ten years; many states declined in absolute terms. Over the same period Wisconsin increased its reliance on property taxes, by 1988 the largest single source of state/local revenue in the state. Property tax increases occurred alongside significant increases in state aid to local governments--especially to local school districts--even though the avowed intent of increased state aid was at least in part to stabilize or reduce property taxation by local governments.

Among Wisconsin's local governments including school districts, intergovernmental aid exceeds the property tax as the largest single revenue source. During the 1980s the targets of intergovernmental aid in Wisconsin shifted as a result of state and Federal actions. Intergovernmental aid and tax credits for school districts--supplied principally by the state--increased rapidly through the mid to late 1980s. Aid to school districts from Wisconsin's Department of Public Instruction and tax credits from state General Appropriations increased from \$998 million in 1983-84 to \$1,671 million in 1987-88--a nominal increase, measured in current dollars, of 67.5 percent and a real increase, discounted for inflation, of 42 percent. Intergovernmental aid and tax credits for other local governments, particularly municipalities--supplied by the state and Federal governments--declined significantly. State aid and tax credits for local governments

other than school districts increased by 3.3 percent from 1983-84 to 1987-88 after discounting for inflation, but total state and Federal intergovernmental aid to municipalities--cities, villages, and towns--declined by 17.4 percent.

Wisconsin's spending growth during the 1980s derived mainly from increases in spending for public elementary and secondary education and, to a lesser extent, public welfare. Real state/local spending per capita in the state increased by \$140 between 1983 and 1988. Real per capita spending for local schools increased by \$124 in the same years, and for public welfare, by \$45 per capita. The combined increase for these two categories exceeds the total state/local increase, and real spending for most other public services has declined. By 1988, Wisconsin's spending for these two categories was 44 percent of total state/local spending in the state, substantially higher than the U.S. average of 37 percent or that of any of its immediate neighbors.

Wisconsin's targeting of state aid on local public education represents, in part, a commitment by Governor Thompson, supported by the legislature, to reach 50 percent state funding of elementary and secondary education. In pursuit of this commitment, intergovernmental aid for local schools has been increased significantly in each recent state budget. The state has not, however, been successful in reaching its 50 percent goal because local school districts have increased their own source revenues--in particular, their local property taxes--in parallel with state aid increases. This action by the local districts, while no doubt frustrating to state officials, is the logical consequence of incentives afforded by the intergovernmental aid formulas used by the state.

State Aid Formulas Drive Local Fiscal Choices

General equalization aid for school districts in Wisconsin varies directly with that portion of school spending counted as "sharable costs". To gain the largest increments in state aid possible from year to year, school districts must increase their own spending significantly, and they have done so. Sharable costs include school operating expenditures and a portion (but only a portion) of school debt service costs, and exclude costs covered by user fees. The result is that, in general, school districts must fund increased local spending with increases in local property tax revenues in order to take maximum advantage of state aid.

General state aid for other local governments--towns, villages, cities, and counties--is distributed in proportion to "aidable revenues," which include charges and fees as well as property taxes. To gain the largest increments in state aid possible from year to year, local governments other than school districts must increase their own source revenues, but have the freedom to choose a mix of property tax and user charge increases. As a result, local government property tax increases, which lagged behind those of school districts, have been matched by significant increases in user charges. Indeed, if one focuses on increased revenues and expenditures from own sources, not just on property taxes, local governments have not been significantly more restrained in local revenue raising than school districts.

Wisconsin state aid formulas (1) reward those school districts that raise more revenue from the local property tax and (2) reward other local governments that raise more revenue from the local property tax plus other charges and fees. The effect is to induce local spending and discourage local economizing. A one dollar increase in local spending requires substantially less than a one dollar increase in locally-raised revenues. A one dollar decrease in local spending also brings less than one dollar's worth of local tax savings due to a decline in state aid. As the state increases school aid, hoping to achieve 50 percent funding, local districts raise their spending so as to qualify for increased state aid. The state's pursuit of 50 percent funding for education, like the quest for property tax relief more generally, is endless--like a cat chasing after its own tail.

Increases in state aid, however, are not the driving force in the chase, but rather, distribution formulas that reward increases and punish decreases in local spending. Although state aid for non-school local governments has increased hardly at all since 1983-84, they have continued to increase their own source revenues significantly. Even in a competition for a relatively fixed pot of state aid, local governments that

raise more revenue locally are rewarded with a bigger share. This distortion of local fiscal decision-making by state fiscal policies is at the root of Wisconsin's property tax relief/spending control dilemma.

Needed Fiscal Reforms

The source of the problem lies not with the amounts allocated for shared revenues and general school aids, but with distribution formulas that tie amounts received to amounts raised in taxes (or spent) by local jurisdictions. To eliminate the effects that state allocations have on the marginal revenue/expenditure decisions of local governments and school districts, it would be necessary to change the basic structure of the distribution formulas. In place of matching payments that vary with the revenue/expenditure levels of local communities, the restructured formulas must rely on "lump sum" payments to local jurisdictions.

Both sharable costs, in the case of school districts, and aidable revenues, in the case of other local governments, must be removed from aid formulas, and replaced with per capita base entitlements that do not change with increases or decreases in local taxing or spending. Per capita base entitlements can still be multiplied by an equalization weight that inversely reflects the relative size of the local tax base, as at present. Although allowance would have to be made for the varying functional assignments and service needs of local jurisdictions, current aid levels can be used as a guide to establishing initial base entitlements--viewed as those amounts to which a local citizen would be entitled given a zero tax capacity. The result would be greater local responsibility for fiscal restraint without having to reduce state responsibility for equalization.

Restructured formulas can be accompanied by new tax rules to reinforce local accountability. Property taxes can be controlled by rolling back rates following reassessment and capping the rates at those levels unless local voters approve increases by means of referenda. This procedure would impose greater fiscal discipline on local officials while not denying fiscal discretion to local communities. If state officials believe that local spending is too high, due to spending inducements supplied by present state formulas, they could test their hypothesis using restructured lump-sum formulas by reducing the overall level of state assistance, allowing local voters to decide whether they want to replace the lost state funds with new local taxes or charges. Or, if state officials were to decide to increase the degree of equalization in state aid, the new formulas would allow them to do so without inducing greater local spending.

Benchmarks for Rethinking Wisconsin Fiscal Policy

The following observations are offered as benchmarks for further reflection on Wisconsin's future fiscal policies:

- * Local property taxes are not inherently flawed as a revenue instrument for supporting local governments. Especially if subjected to institutional controls, including reassessment limits to avoid tax windfalls and voter referenda to approve rate hikes, they are a responsive, equitable, and accountable local revenue source. States, such as California and Massachusetts, that have in effect removed the property tax from local discretion have lost an important and useful fiscal instrument--useful both for holding local officials accountable and for expressing local demand for goods and services. Differences in property wealth among local communities can be addressed by a combination of statewide redistribution and local-option taxes on other revenue bases.
- * Neither a large number of local governments nor autonomous local decision-making present obstacles to local fiscal responsibility. Total local demand for goods and services in Wisconsin can be treated as the sum of demands across all local jurisdictions plus statewide support for equalization, as long as marginal decisions at the state and local levels are independently made. Designing appropriate fiscal institutions is more important than determining statewide goals for local taxing and spending.

- * Wisconsin is unlikely to benefit from employing any of the standard approaches to tax and expenditure limitation found in most other states unless changes first are made in the formulas for distributing shared revenues and general school aids. Rather than imposing artificial limits, state legislators should allow local demand to constrain local spending by removing state incentives to spend. The constraint provided by local demand can be reinforced by requiring that voters approve both property tax rate increases and the imposition of local-option taxes.
- * It is not the amount of state financial assistance provided as a percentage of local spending that potentially distorts local decision-making, but rather the way in which state assistance is distributed. Revenue sharing formulas that tie amounts received to local taxing and/or spending levels affect local decisions at the margin, where increases and decreases are decided, and therefore reduce local responsibility. Lump-sum payments do not affect local decisions at the margin, yet can be calculated to have an equalizing effect.

INTRODUCTION

Throughout the late 1970s and the 1980s, state and local public finance in the United States was the subject of much study and debate, both academic and practical. The "Tax Revolts" of the late 1970s triggered much of this interest, as citizens of many states began to articulate their perception that their state and local governments had become big enough or even too big. The decline in Federal aid to local governments in the 1980s was another stimulus for study and debate, as states and localities have been forced to consider how much of this aid to replace as well as the share of the new fiscal burden to be borne by each level of government. Competition for economic development was yet another stimulus, as states and localities have had to consider the effects of their taxing and spending packages on their relative attractiveness to old and new firms. In all of these discussions, public accountability has been a prominent issue--the question of how the choices made by elected and appointed officials can be constrained by and made responsive to the preferences of citizens they are employed to represent and serve.

All of these issues have been reflected in public policy discussions and debates in Wisconsin. Local public finance has long been a concern in Wisconsin, especially with regard to perceived increases in local property taxes and the appropriate role of the state in local finance. In the mid 1980s, economic development became a major concern in Wisconsin, particularly a perceived linkage between high tax rates--especially the state's income taxes--and disincentives for firms to remain in or relocate to Wisconsin. In partial response to this concern, Wisconsin cut personal income tax rates significantly.

To contribute to informed discussion of these issues in Wisconsin--especially the issue of local fiscal accountability--the Wisconsin Policy Research Institute commissioned the study reported herein. The Joyce Foundation of Chicago agreed to give full support for the research. The study consists of several related parts. In Chapter One recent trends in state/local finance nationally, in Wisconsin, and among its neighbors are explored, extending the work of the 1986 Wisconsin Expenditure Commission to the most recent year for which comparative data are available--1988. Chapter Two is focused on fiscal trends at the local level in Wisconsin, attempting to understand those trends as the result of rational responses by Wisconsin's local officials to exogenous changes in their fiscal environments and state fiscal rules. The way that these changes have engendered relative changes in local property taxing and the use of other revenue sources is explicated. In Chapter Three, the report examines the effects of fiscal limitations from a 50-state perspective, and Wisconsin's recent experience is placed within the national context. Chapter Four explores local fiscal limitation measures in selected states in an effort to understand how different approaches to fiscal limitation affect local public finance. In Chapter Five, the report draws on the findings of the study to help in understanding Wisconsin's fiscal rules and the fiscal politics they have engendered. Suggestions for restructuring of fiscal rules in the state to enhance local fiscal accountability are presented to help inform current debate in the state.

The perspective taken throughout the report is that the best choices of revenue and spending policies for Wisconsin are choices that reflect the informed preferences of Wisconsin's citizens. Public spending in Wisconsin or any other state cannot be considered too high nor too low by any absolute standard nor by comparison with that found in other states. Rather, state revenue-raising and expenditures, and those of localities within the state are "correct" if they are responsive to what informed citizens want in the way of public goods and services and what they are willing to pay for those goods and services. Revenues or expenditures that are "too high" (or "too low") as a result of fiscal practices that distort citizen preferences, or mislead citizens with respect to real costs and benefits pose a problem from this perspective. Preferred fiscal practices are those that allow citizens in local and state-wide communities to make fiscal choices informed by careful consideration of what they want from their government, and what their wants will cost.

In the remainder of this introduction, we first summarize the recent history of fiscal politics in Wisconsin, then discuss the nature of local public finance from an economic perspective, and conclude with an introduction to the analytic perspective used in this report--the study of local fiscal constitutions.

Wisconsin's Recent Experience in Fiscal Politics

Throughout the 1980s, Wisconsin labored over the twin issues of property tax relief and the control of state/local spending. The attention of the state legislature was most often focused on property tax relief, while the Wisconsin Expenditure Commission, appointed by former Governor Anthony S. Earl in 1985, focused on spending. The two concerns are, of course, interrelated. Effective property tax relief requires local restraint; otherwise tax dollars spent for relief may instead finance increases in local budgets. The quest for property tax relief, in the absence of local spending restraint, can contribute to local spending growth. At the same time, however, the two concerns are differently focused. Concern over high property taxes leads to efforts to shift the tax burden away from property taxpayers. Concern over high spending leads to efforts to control or reduce spending.

The decade of the 1970s was a period in which Wisconsin experimented with levy limits on local governments and cost controls on school districts. The Wisconsin Expenditure Commission evaluated this experience as follows:

The principal reason given for the failure of school district cost controls and municipal levy limits in the 1970s was the many appeals and exceptions granted by the Legislature. In granting those exceptions, the Legislature was responding to legitimate problems with uniform controls imposed upon a diverse set of local circumstances. Once granted, however, each exception was available to every local government, regardless of the situation. The combined result was an undermining of the expenditure controls.¹

The central thrust of recommendations made by the Wisconsin Expenditure Commission in 1986 was to establish a state goal to reduce the rate of growth in state/local spending so as to reach the U.S. average level of state/local spending as a percentage of personal income by 1992-93.² Two principal means were identified to achieve the goal. One was the calculation of an annual allowable growth rate necessary to reach the current U.S. average by 1992-93, with annual increases in state general purpose revenue expenses (including shared revenues and aids to local governments and school districts) limited to that rate. The other was the imposition of a limit on local employee salary and fringe benefit increases by limiting arbitration awards under the state's collective bargaining law to the calculated annual growth rate. The Commission rejected levy limits and cost controls as too inflexible, and concentrated instead on "the one common element" in municipal and school district expenditures--personnel costs.³ No formal action was taken on either of the Commission's two major recommendations, although the goal is still often cited in on-going political debates, and is supported by the new Republican Governor, Tommy G. Thompson.⁴

Another state commission--the Local Property Tax Relief Commission--was appointed by Governor Thompson in 1987. Its basic recommendation was to transfer much of the cost of local education from property taxes to the state through a new school aid formula. Briefly, each school district would be required to levy a property tax rate of at least \$4 per \$1,000 of assessed valuation. The state would make up any amount then needed to reach a minimum spending level per student, initially set at \$4,200, the average spending per student in 1986. Increases in spending to reach the minimum level would be phased

¹ Wisconsin Expenditure Commission, *Final Report*, December 1986, p. 51.

² *Ibid.*, p. 11.

³ *Ibid.*, pp. 22-23.

⁴ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 3, February 5, 1988.

in over a five-year period. Temporary limits would be instituted on local property tax levies, except where increases were necessary to reach the minimum school funding goal.⁵

Without adopting the Commission's approach to school finance, but attempting to deliver on a campaign pledge to fund 50 percent of school costs with state dollars, Governor Thompson subsequently proposed to increase state aids to school districts based on a revised school equalization formula that would decrease state support as local costs per pupil increased.⁶ At the same time, the governor proposed that limits be imposed on all local expenditures, levies, and personnel compensation. For three years, growth would be limited to percentage increases in the consumer price index; afterward, growth would be limited to the percentage increase in Wisconsin per capita personal income. Overrides of the spending and levy limits would be permitted by popular referendum; overrides of the compensation limit, by extraordinary majority vote of the governing body.

The legislature declined to enact the governor's package, but did propose two amendments to the state constitution. One amendment would have changed the constitution's tax uniformity clause to allow the legislature to supply tax relief differently to different groups of taxpayers, as long as the effect is progressive.⁷ Readied for legislative action if the amendment were approved by the voters was a proposal to give residential property owners and renters (with household incomes under \$83,000), an income tax credit for property tax payments or rent exceeding 3 percent of total income, as long as the credit did not exceed \$1,000 or 80 percent of the property tax. Similar relief would be supplied to farmers. State voters, however, narrowly defeated the proposed amendment.⁸ The second proposed amendment would have phased out local finance of schools from the property tax, but was defeated in the legislature on the second-round of voting required to place a constitutional amendment on the ballot.

One change the state has experimented with as a means of increasing the effectiveness of property tax relief has been to change its form. During the 1980s, property tax credits were favored over increased payments to local governments and school districts as a method of providing additional property tax relief. Although a proposal by the 1985 legislature to convert all shared revenues and general school aids from payments to local governments and school districts to property tax credits⁹ was not implemented, the legislature has come to rely more heavily on the property tax credit device. The intent is to require local governing bodies to increase local tax rates if they are to capture state-supplied property tax relief for local budgets. Research done by the Wisconsin Expenditure Commission revealed, however, that the form in which relief is supplied has no consistent relationship to the level of property tax relief actually realized in local communities.¹⁰ Presumably, local officials are able to anticipate the size of the credit and use these estimates in planning the size of the local levy. Most recently, the state introduced a school levy credit applied to the state personal income tax, thus attempting to separate still further the state's property tax relief efforts from local taxing and spending decisions. However, most state assistance to local communities continues to be distributed as payments to local governments and school districts.

⁵ The recommendations of the Commission are summarized by the Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 31, October 5, 1987.

⁶ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 2, January 29, 1988.

⁷ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 6, February 17, 1989.

⁸ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 13, April 7, 1989.

⁹ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 23, June 25, 1985.

¹⁰ Wisconsin Expenditure Commission, *op. cit.*, p. 26.

Amid the flurry of commission reports and rival proposals to restructure the fiscal relationship between state and local governments in Wisconsin, the dominant political focus of the 1980s has remained traditional property tax relief, reflected in increasing state allocations for this purpose. The 1985-87 budget, for example, provided for a 23 percent increase in school aid, shared revenue, and property tax relief payments to local governments over 1983-85.¹¹ In 1988, the Democratic controlled legislature and Republican governor reached a virtual stalemate over property tax relief--the legislature rejecting the governor's proposals and the governor vetoing the legislature's efforts.¹² The most recent state budget, 1989-91, continued the traditional approach to property tax relief without enacting any major changes in fiscal rules. Appropriations were again increased for shared revenues and school aids. A homestead tax credit was increased and a new farmland tax credit was established. The school levy tax credit against the state income tax was also increased.¹³ State assistance to local governments thus continued to grow, without any promise that the elusive goal of property tax relief would be achieved.

Economic Problems in Local Public Finance

In order to make sense of fiscal experience and address its difficulties, it is necessary to draw on theories of political economy that point to pertinent relationships and problems. Economists have identified a number of related problems that can lead to distortions of local fiscal decisions. Most of these problems stem from the lack of a quid pro quo between individual consumers and the producers of public goods and services. The resulting separation of taxing decisions from spending decisions, unlike the individual consumer who taxes his wallet as he spends his money in the marketplace, potentially creates numerous difficulties.

Taxes impinge differently on individual citizens than do the goods and services provided by tax dollars. As an out-of-pocket expense, taxes are usually experienced directly by individuals.¹⁴ Public benefits are not only shared with others but also are often experienced indirectly (e.g., capturing a burglar benefits one victim directly and an unknown number of future victims indirectly). The asymmetry between costs and benefits in the experience of citizens creates a bias against the provision of public goods, leading voters and vote-seeking politicians to support reduced levels of taxation. Other things equal, this would lead to levels of spending in a democracy that are too low by standards of economic efficiency.¹⁵

Other things, however, are not necessarily equal. If citizens as taxpayers are stingy, citizens as consumers of public goods and services can be profligate. As Henry Wallich put it,

when it comes to accepting benefits the citizen-taxpayers act like a group of men who sit down at a restaurant table knowing that they will split the check evenly. In this situation everybody orders generously; it adds little to one's own share of the bill, and for the

¹¹ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 25, July 18, 1985.

¹² Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 13, May 17, 1988.

¹³ Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 28, August 8, 1989.

¹⁴ The exception is when taxes are passed on to others in a different form, e.g., when landlords pass on higher property taxes to tenants in the form of higher rents.

¹⁵ Anthony Downs, "Why the Government Budget Is Too Small," in Edmund S. Phelps, *Private Wants and Public Needs*, New York: Norton, 1965, pp. 76-95.

extravagance of his friends he will have to pay anyhow. What happens at the restaurant table explains -- though it does not excuse -- what happens at the public trough.¹⁶

The political demands of citizens for services need not equate to an economic demand in the sense of a willingness and ability to pay for services provided. In an interest-group society, as various groups simultaneously press demands, the result can be a steady upward political pressure on public expenditures, leading to an argument that taxes "need" to be increased. If the benefits of specific public projects are highly concentrated on particular groups of voters while the tax costs are widely shared, the political demand for spending can be reinforced by a "fiscal illusion" that public goods are costless.

Other factors can also influence taxing and spending in an upward direction. Both politicians and service producers have incentives to support greater over lesser public spending. In the case of politicians this tendency can be outweighed by a desire to please voters, but not necessarily. Politicians clearly stand to gain from having large sums of money available to spend as they choose. Service producers benefit from increased budgets, whether because of greater compensation and perquisites of office available to public bureaucrats or because of a sense of mission associated with enhancing the supply of particular public services.

In addition, absent a profit motive in the public sector, producers have relatively weak financial inducements to be efficient. The benefits of increased productivity, rather than adding to profits, flow instead to citizen-taxpayers either as tax savings or as increased services. The absence of a profit-maker means that no one has a direct financial incentive to increase the efficiency of public performance. Inefficiencies in production drive up the costs of public services and, therefore, reduce service levels and/or increase taxes. Moreover, government agencies are frequently monopoly producers, leaving both elected officials and voters in a position of having to choose between higher and lower service levels rather than seeking to improve efficiency by changing producers.¹⁷

How the various cross-cutting influences identified by economists actually combine to affect levels of taxing and spending depends on political institutions--the governmental arrangements used to link the decisions of voters, elected officials, and service producers. No one can say, as a general matter, that public spending tends to be too high or too low, according to economic efficiency criteria. There is no reason to believe, however, that the diverse factors at work would always happen to counteract one another in such a way as to generate satisfactory results. In addition to studying fiscal trends and patterns on an assumption that democratic processes are working smoothly, it is important to take account of the ways that differently structured political institutions can affect fiscal decisions.

Local Fiscal Constitutions

Fiscal choices--taxing and spending decisions--are made within a framework of rules that can be termed a "fiscal constitution."¹⁸ Local taxing and spending decisions throughout the United States are made within the constraints and opportunities created by state law. We consider these legal frameworks to be fiscal constitutions, not in a formal sense, but in a functional sense: Rules are made that assign political discretion to tax and spend, within specified limits. These rules structure the alternatives available to local officials and citizens and offer incentives that shape fiscal decisions in one way or another. But subject to

¹⁶ Henry C. Wallich, "Public versus Private: Could Galbraith Be Wrong?" In Phelps, *op. cit.*, p. 53.

¹⁷ William A. Niskanen, *Bureaucracy and Representative Government*, Chicago: University of Chicago Press, 1971.

¹⁸ This concept was introduced by Geoffrey Brennan and James M. Buchanan, *The Power to Tax: Analytical Foundations of a Fiscal Constitution*, New York: Cambridge University Press, 1980.

the rules, politicians and citizens make choices that combine to produce particular taxing and spending patterns. Fiscal patterns derive from political choices, but the characteristic politics of local taxing and spending found in any state emerges from its fiscal constitution. To alter recurrent patterns of political choice, it may be necessary to redesign the fiscal constitution, rather than simply exhort officials and citizens to behave differently. If a state finds itself trapped in a repetitive cycle of decision-making that leads to ever decreasing fiscal accountability, breaking out of the cycle may require a willingness to step back from day-to-day politics, reflect on the logic of the situation, and rethink the structure of the basic rules used to make fiscal choices.

The design of a local fiscal constitution is itself a matter of political choice. Table I-1 outlines the major elements of a local fiscal constitution. Below, we discuss selected features and discuss alternative design possibilities.

Choice of Allowable Tax Bases

A local fiscal constitution must specify allowable tax bases and other revenue sources available to local governments. Historically, local governments were limited to taxes on property--real and personal. Today, many states allow local governments access to a variety of tax bases--most commonly, retail sales and income, plus a range of nuisance taxes. Local governments are also authorized, with varying limitations, to levy charges on the users of services. Each of these revenue sources can be subject to detailed regulation of what is included and what is not included as part of the allowable revenue base.

Tax bases differ in their "elasticity"--the degree to which revenues expand and contract with the economic wellbeing of a community. Wealth, income, and consumption are alternative bases for computing tax bills. Both income and sales taxes are highly elastic. Property taxes, still the most popular local revenue source, require a separate decision about the valuation of the base--assessments. Regular and frequent reassessment can make the property tax quite elastic even though its elasticity may not be highly correlated with changes in disposable income. If frequent reassessment is made routine, property taxes can be an elastic source of revenue, matching or exceeding the rate of economic growth in a community.

Arguments in favor of greater tax elasticity draw on the idea that citizens tend to undervalue public services, which are experienced indirectly, relative to their tax bills, which are experienced directly. Elasticity can also be viewed, however, as a source of fiscal illusion--a way of disguising increases in tax bills without having to increase tax rates. In addition, lacking strong incentives toward efficiency, the public sector may absorb "automatic" revenue increases without concomitant increases in service levels.

In addition to elasticity, arguments are made in behalf of a reliance on multiple tax bases in order to increase revenue flexibility. Taxpayers frequently focus on particular tax bills instead of on the total amount paid in taxes. Different tax bases also affect different taxpayer groups differently. Relying on various tax bases can enhance revenues by more evenly distributing the tax burden among groups of taxpayers. It can also be argued, however, that a reliance of a large number of revenue sources increases fiscal illusion by making it difficult, if not in some cases impossible, for taxpayers to evaluate the size of their total tax bill for local goods and services. Too much dispersion of local revenues across multiple tax bases can reduce fiscal accountability to local taxpayers.

Some taxes are also more "exportable" than others. Residential property taxes, tied to the location of property, are perhaps the least exportable source of local revenue. Both income taxes and sales taxes can potentially be exported to non-residents, as can commercial and industrial property taxes. In general, property taxes are considered a benefit-based tax when used to support local public goods, especially infrastructure investment and maintenance that tends to increase the value of property that is not highly mobile, such as private homes and commercial buildings. Having a benefit base makes property taxes a useful fiscal instrument for expressing economic demand for many local public goods and services.

TABLE I-1 MAJOR RULES COMPOSING A LOCAL FISCAL CONSTITUTION

- * Allowable Revenue Sources: Property, Sales, Income, Other
 - * Definition of the Property Tax Base (exemptions)
 - * Taxable Sales (exemptions)
 - * Allowable User Charges
- * Property Tax Procedures/limits [Levy = Assessed Value X Rate]
 - * Assessment procedures/limits
 - * Rate limits and rollbacks
 - * Levy limits [see below]
 - * Public notice and hearing requirements (truth in taxation)
 - * Overrides: (1) referenda or (2) state agency
- * Other Rate Limits/Procedures
- * Levy/Revenue/Expenditure Limits
 - * Basis of limit: (1) percentage based or (2) indexed to (a) personal income and/or (b) inflation and/or (c) population.
- * Debt Rules
 - * Limits on amount of debt
 - * Procedures: Referenda, Voting rules.
- * State Assistance
 - * Replacement or Equalization Principle
 - * Lump-sum or matching payments
- * Spending mandates
 - * State payment for mandates required or not required

User charges, when calculated on a cost-of-service basis and earmarked to support those specific services, are also benefit-based. The source of revenue least like taxes, user charges nonetheless retain some tax characteristics. Whether a user charge, like a tax, is a compulsory payment depends on whether use is compulsory. If garbage pick-up is a service that local residents are required to use, then a garbage fee is more like a flat tax than, say, a charge for library use, which is optional. Potentially, both charges can convey information to citizens about the actual costs of services, though not about the costs of alternative production modes. Less information is conveyed if user charges are combined with taxes to support service provision, or if charges are commingled with other sources of revenue in a general fund and thus not tied to provision of a specific service or simply not calculated on a cost-recovery basis. In any case, user charges are politically or administratively determined, not market determined; and user charges are appropriate only for services that can be metered (like water service) or otherwise easily measured (like once-per-week garbage pick-up). Services, like police, that provide communities with intangible benefits, such as security from crime, cannot be metered to individual households. A user charge in this case would be indistinguishable from a flat tax.

Rules for Setting Tax Rates

Apart from elasticity, revenues change from increases or decreases in the tax rates applied to a base. For each revenue source, a local fiscal constitution must specify who sets tax rates or charges, within what limits, if any, and subject to whose approval, if anyone. Local rates can be fixed by state law, although usually state legislation imposes a rate cap and allows localities to raise rates up to the statutory limit. Some taxes, usually called local-option taxes, establish a single rate (or a very limited rate structure) and allow localities only an all-or-nothing choice. In most cases localities exercise their discretion either by the vote of elected representatives who make up a governing body or by direct vote of the electorate in a referendum. It is important to distinguish limits on local officials from limits on local communities. Some limits on the discretion of local governing bodies shift authority to local voters, who are allowed to override limits. Voter override rules avoid denying the local community the freedom to determine its own tax rates, while limiting the discretion of local officials acting on their own.

Because elected officials are accountable to voters, it is sometimes assumed that tax referenda are redundant and unnecessary. Elections, however, have weaknesses as instruments of accountability. In particular, the process of choosing among candidates for office suffers from a simultaneous issues problem. Voters cannot express their preferences on single issues, but must choose candidates based on a package of issues. Long and/or staggered terms of office can also dilute the power of the electorate to affect the specific policy choices of their representatives. If terms are staggered, two or three elections may be required to create a new majority in a local legislative body. Election-year tax increases are rare.

Revenue Transfers between Jurisdictions

Local revenues need not be raised locally. States must decide whether state revenues will be used to offset the costs of local governments and, if so, on what basis. Typically, the local jurisdiction that makes spending decisions raises only a portion of its own revenues, receiving the remainder in intergovernmental transfers. Some transfers are conditional grants made for specific projects or purposes in such a manner that the grant resembles a purchase of service agreement. Most state aids to local governments, however, are unconditional transfers, created as an instrument of tax sharing.

Various methods of tax sharing can be used. One possibility is to share revenues on a replacement basis, a method by which revenues are raised on a statewide schedule but returned to the jurisdiction of origin. Another possibility is an equalization basis, intended to correct to some extent for variation in the distribution of taxable resources among local jurisdictions. If an equalization basis is selected, legislators also face a choice of distribution mechanisms. The two major alternatives are (1) lump-sum payments, often on a per capita basis, and (2) matching payments that vary with levels of local taxing or spending. Lump-sum payments do not affect the marginal taxing and spending decisions of local jurisdictions, while matching payments tend to stimulate local taxing and spending. Often state or Federal governments may want to

stimulate local taxing and spending on particular goods or services and, therefore, design categorical grant programs on a matching basis; but seldom would state governments want to stimulate local taxing and spending in general.

Putting It All Together

It is the combination of rules, more than individual rules taken separately, that matters in the design of fiscal constitutions. For example, the effect of allowing a particular tax base depends on allowable rates. If property tax rate limits are set quite low, and no overrides are allowed, the tax becomes unavailable as a fiscal instrument for expressing local demand for goods and services. Instead of a local tax source, it becomes more like a lump-sum grant. Because the property tax levy equals assessed valuation times the tax rate, efforts to limit levies by limiting rates can fail to constrain tax bills if assessments are unlimited. If matching payments rather than lump-sum payments are used to distribute shared revenues to local governments, limits on local taxing or spending are sometimes instituted in an attempt to assure that state efforts to provide property tax relief do not simply support further increases in local budgets. Setting strict limits on one revenue source, however, may simply drive local governments toward other revenue sources that are not so limited, or simply more elastic.

Fiscal rules do not directly determine patterns of taxing and spending. If they did, no question would arise about the actual effect of tax and expenditure limitations--the rule would simply determine the outcome. Instead, rules simply establish the terms and conditions under which people make choices. Combinations of rules can create incentives that lead to counterintentional results. State legislators, together with the political communities they represent, need to recognize that they act on two different levels. At one level, they decide what taxes to levy and how much money to spend in what ways--all within a set of rules. At another level, they must reflect on the patterns of taxing and spending in which they have engaged, analyze the ways in which the rule structure affects their combined choices, and, if necessary, restructure the rules that govern their interactions. Note that it is not adequate simply to add a new rule without considering its joint effect with other rules. When the politics of taxing and spending have gone awry, and the recurring political process is one that seems to feed on itself, the remedy necessarily lies in rethinking and redesigning the fiscal constitution.

RECENT STATE/LOCAL FISCAL TRENDS

Wisconsin, Its Neighbors, and the Nation

Although the major purpose of this report is to assess local fiscal accountability in Wisconsin, we first review briefly recent trends in combined state and local revenues and expenditures in Wisconsin compared to its neighboring states of Illinois, Iowa, Michigan, and Minnesota, and to all states in the aggregate.

State/Local Revenue Trends

The decade of the 1980s, especially the years after the recession of the early 1980s, has been a period of rapid growth in state/local revenues in the United States. General revenues of state and local governments nationwide exhibited real growth, discounting the effect of price inflation, of 14.6 percent in per capita terms between 1983 and 1988 (Figure 1.1).¹ During this period, Wisconsin's growth in per capita state/local revenues was significantly lower--6.4 percent in real dollars per capita. Among Wisconsin's neighbors, only Michigan exhibited similar slow growth--also 6.4 percent--as Illinois, Iowa, and Minnesota increased their real per capita revenues by 9.4, 15.7, and 12.8 percent respectively. In spite of its relatively slow revenue growth in this period, Wisconsin remained in the middle of its neighbors in real per capita revenues by 1988--below Minnesota and Michigan, and above Iowa and Illinois. Wisconsin moved much closer to the national average, however. Its real per capita revenues in 1983 were 10 percent above average, but were only 2.2 percent above average in 1988.²

Wisconsin's state/local revenues as a percent of personal income in the state declined between 1983 and 1988--from 21.2 to 20.7 percent--while nationally, state and local revenues grew from 18.8 to 19.2 percent of personal incomes (Figure 1.2). Wisconsin's decline by this measure--one half of one percent--was second largest among its neighbors, exceeded only by Michigan's one and one-half percent drop. Still, in 1988, Wisconsin ranked second highest among its immediate neighbors in state/local revenues as a percent of state personal income.

State/Local Revenue Sources

Wisconsin has changed its sources of revenues in recent years. Like virtually every other state, its reliance on revenues from Federal sources declined. In 1978, Federal revenues were just over 20 percent of state/local revenues in Wisconsin, but by 1988 they were 16.2 percent. However, Wisconsin's decline in Federal revenues--\$51 per capita in deflated dollars--was substantially less than the average decline nationwide--\$80 per capita (Figure 1.3). As a result, Wisconsin in 1988 was slightly above average among the states in per capita Federal revenues, while it had been below average in 1978.

¹ Source: U.S. Bureau of the Census, *Governmental Finances in (fiscal year)*. The price deflator used in this report, unless indicated otherwise, is the implicit price deflator for state and local purchases of goods and services, found in the *Survey of Current Business*, July issues.

² The national average is just that--an average--not necessarily a target for any particular state. Wisconsin's standing relative to national average revenues and those of its immediate neighbors is presented here to provide comparative perspective, not prescription.

FIGURE 1.1

General Revenues per Capita [\$1982] Wisconsin and Neighboring States

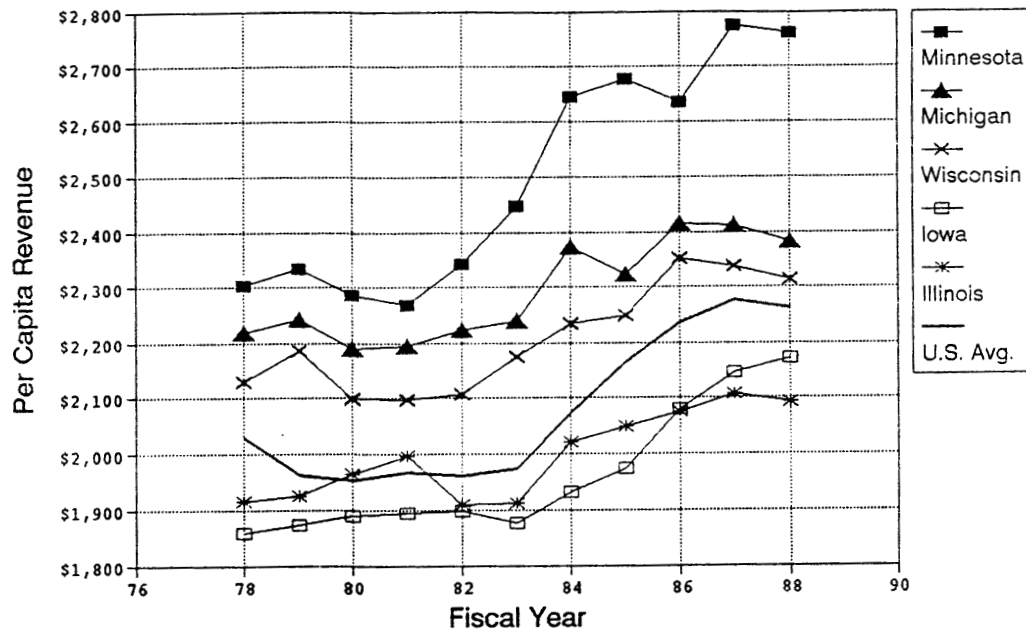


FIGURE 1.2

General Revenues Percent of Income Wisconsin and Neighboring States

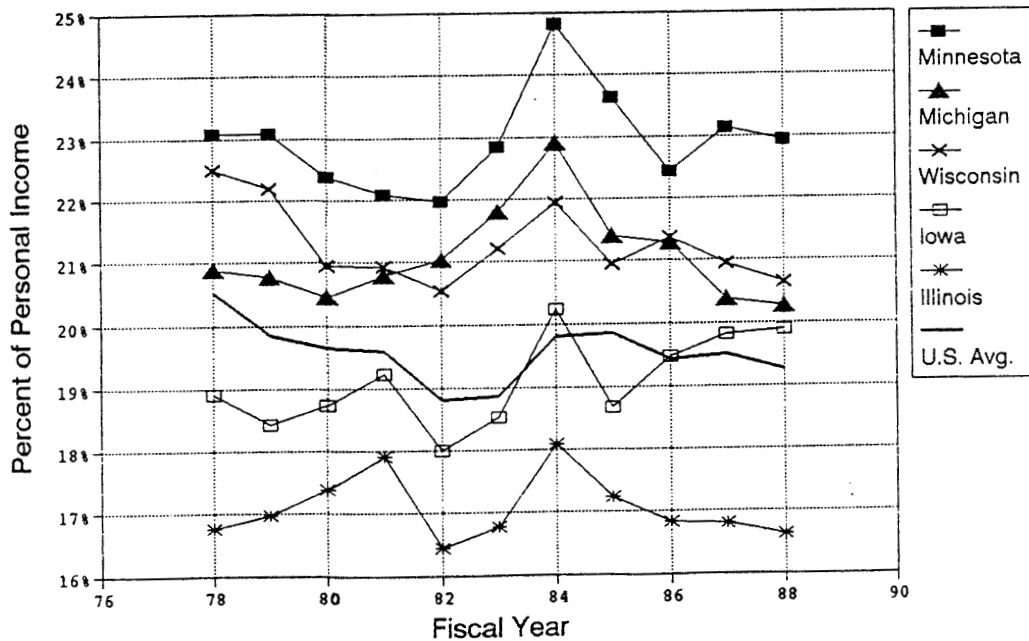


FIGURE 1.3

Change in State/Local Revenue Sources Wisconsin and US 1978-88: [Real \$1982]

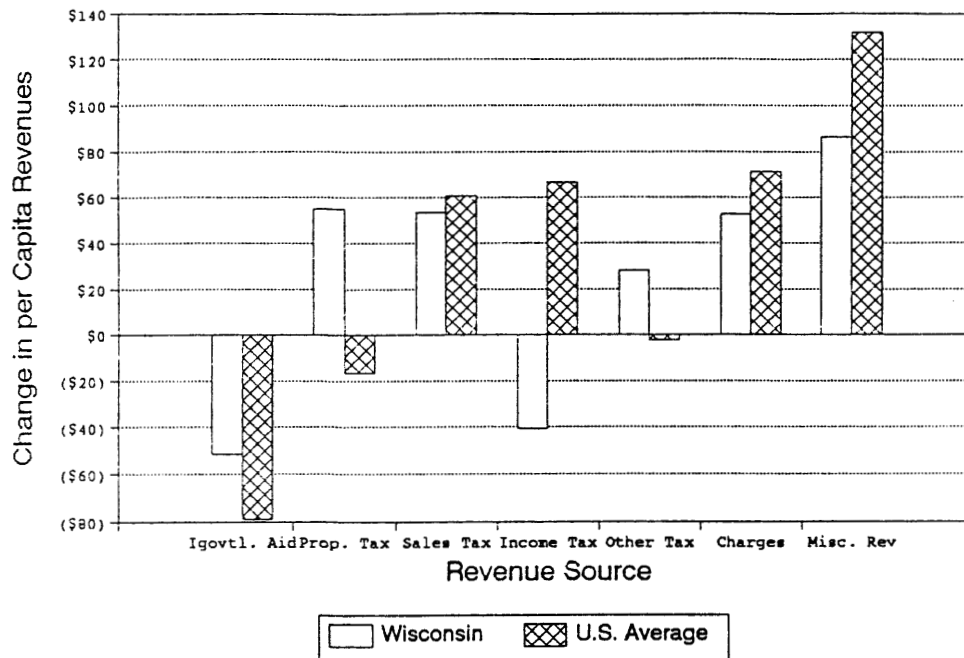
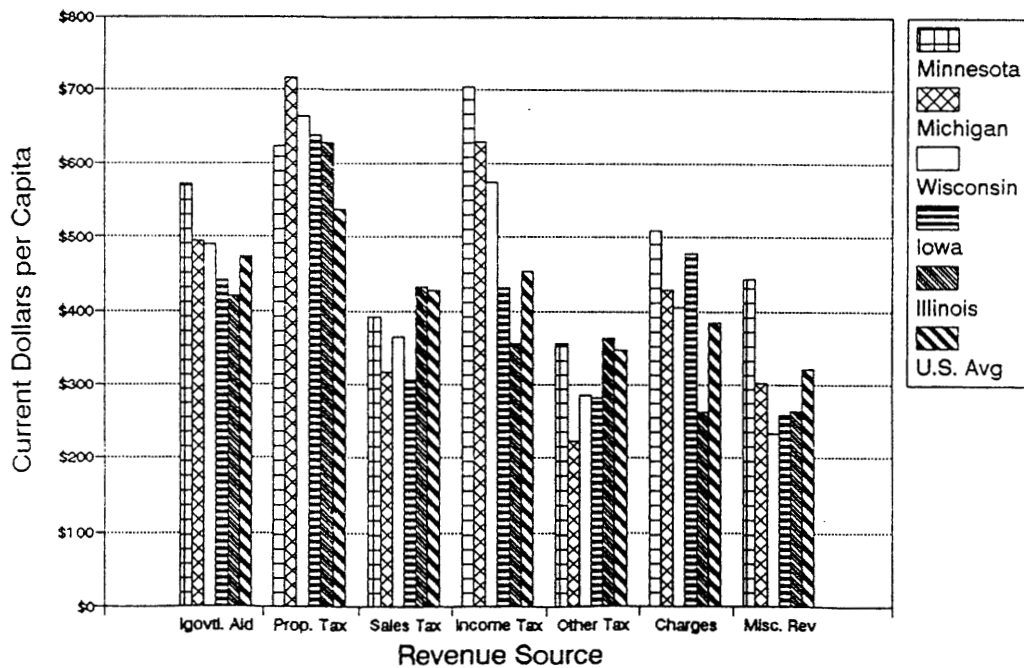


FIGURE 1.4

General Revenues By Source Wisconsin and Neighboring States - 1988



Income taxes declined as a share of Wisconsin revenues and in real dollars per capita during this period, while other sources of revenue became more important to the state. By 1988, the property tax had become the largest single source of state/local revenues in Wisconsin. Wisconsin's increasing reliance on the property tax over this period was counter to national experience, where property taxes dropped from 21.1 percent to 18.2 percent of state/local revenues. Wisconsin's general sales tax and other non-income-based taxes together yielded revenues exceeding those from the state's income tax, as did combined revenues from user charges and miscellaneous non-tax sources.

In 1988, Wisconsin's per capita revenues from the property tax were higher than those of any of its neighbors except Michigan, and were roughly 124 percent of the national average (Figure 1.4). Its income tax revenues relative to population also remained above average, but less than those of Michigan and Minnesota. Wisconsin in 1988 was below average in its per capita revenues from the sales tax and other taxes not related to income or property, somewhat above average in its reliance on user charges, and well below average in its revenues from miscellaneous non-tax sources.

State/Local Expenditure Trends

Following a modest decline during the early 1980s, combined state/local real spending nationwide--discounted for price inflation--increased significantly relative to population (Figure 1.5). The increase from 1982's low point through 1988 was 20.4 percent nationwide--real growth of more than 3 percent annually. Wisconsin's real spending growth relative to the state's population was much lower--only 6.5 percent over the six years, less than 1.1 percent annually. In 1982, Wisconsin's state/local spending per capita was 17 percent above the national average, but by 1988 it was only 3.7 percent higher, below its neighbors Minnesota and Michigan, and higher than Illinois or Iowa.

Nationwide, state/local general expenditures relative to income declined through the late 1970s, with a major dip in 1982, but have rebounded since then (Figure 1.6). Wisconsin's trend in spending relative to income was generally decreasing throughout the last ten years, but by this index the state remains well above the U.S. average. In 1988 state/local general expenditures in Wisconsin were 20.3 percent of the state's personal income, 109 percent of the national average. This placed the state at the same level as its neighbor, Michigan, and below only Minnesota among neighboring states.

Wisconsin's expenditure growth in recent years has resulted principally from increases in spending for public elementary and secondary education and, to a lesser extent, public welfare. Real state/local spending per capita in the state increased by \$140 between 1983 and 1988. Real per capita spending for local schools increased by \$124 in the same years, and for public welfare, by \$45 per capita (Figure 1.7). Because the combined increase for these two categories exceeds the total state/local increase, real spending for most other public services has declined. By 1988, Wisconsin's spending for these two categories alone was 44 percent of total state/local spending in the state, substantially higher than the U.S. average of 37 percent or that of any of its immediate neighbors.

Wisconsin's increase in spending for public welfare has been a topic of significant discussion in the state. In 1986, the Wisconsin Expenditure Commission noted that "welfare spending is a significant contributor to the state's overall high ranking for state and local spending,"³ and drew attention to the increase in this category of spending from the middle 1970s forward. The Commission also drew attention to Wisconsin's relatively high spending for local schools, but did so at a time when the recent rapid increase in elementary and secondary education spending had only just begun. In the next chapter, where recent local fiscal trends in Wisconsin are analyzed, spending for local schools is a major focus.

³ Wisconsin Expenditure Commission, *Final Report*, December 1986, p. 44.

FIGURE 1.5

General Expenditures per Capita [\$1982] Wisconsin and Neighboring States

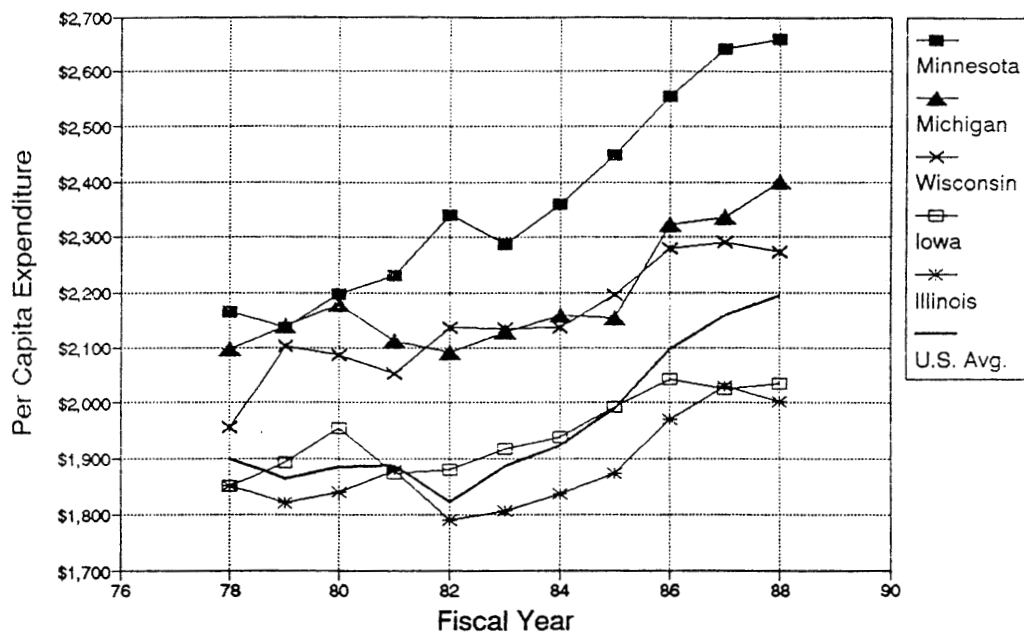


FIGURE 1.6

General Expenditures Percent of Income Wisconsin and Neighboring States

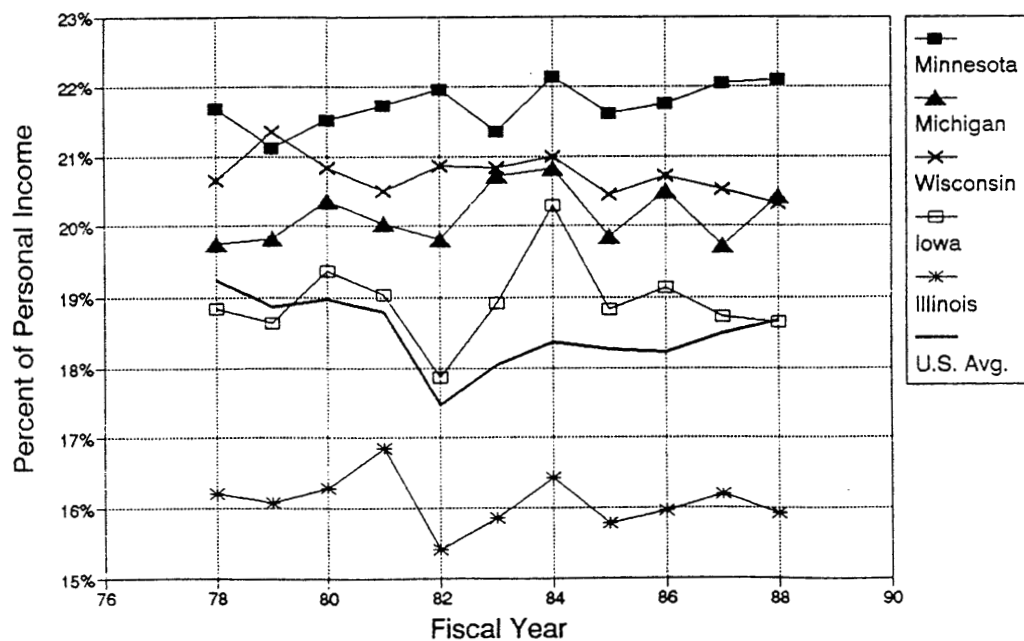
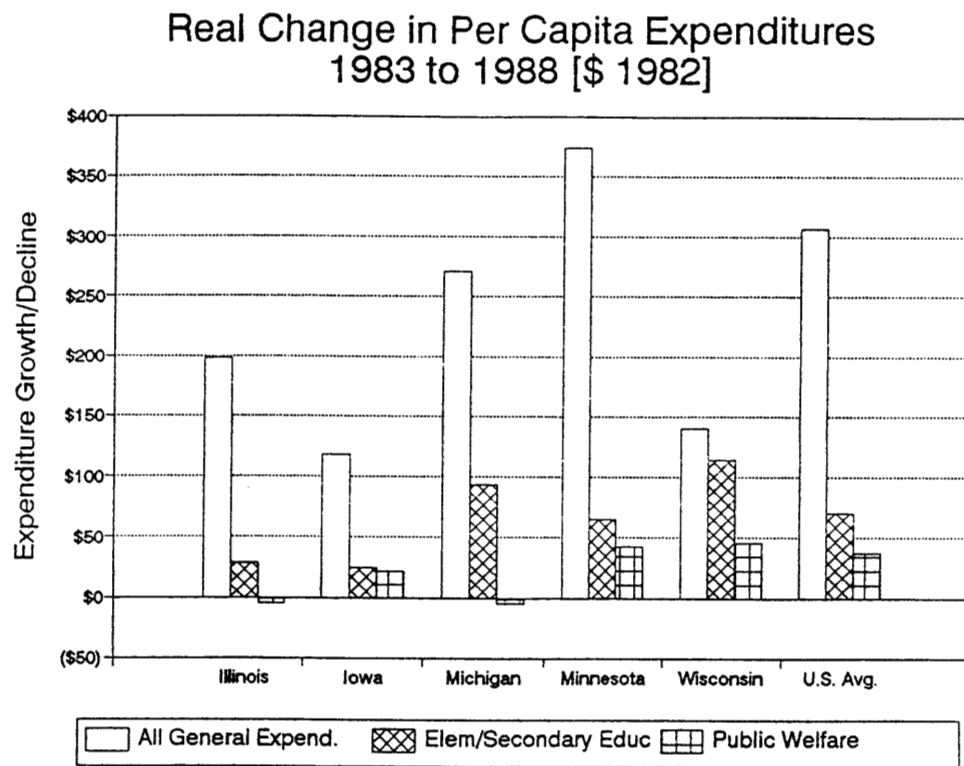


FIGURE 1.7



RECENT LOCAL FISCAL TRENDS IN WISCONSIN

Rational Responses to Environmental Change and Fiscal Rules

Examining trends in local fiscal relationships in Wisconsin during the 1980s, an observer is struck by several changes. First, and most striking, real spending for elementary and secondary education (discounting the effects of price inflation) has increased substantially. Second, state aid and property taxes levied for local education have increased significantly, while charges and fees levied for educational purposes have declined. Third, property taxes levied by local governments other than school districts have increased, as have charges and fees imposed by these governments, but spending for local services other than education has remained essentially constant relative to population.

Upon investigation, it would appear that these changes represent rational responses by local officials to changes in their external fiscal environments, and to fiscal rules imposed by state government. External fiscal changes have altered the relative local price of public goods and services in recent years, reducing the local cost of educational spending increases relative to spending increases for other services. Rules affecting the local cost of user charges and fees have made their use more expensive for school districts than for other governmental units. These external changes and state rules would, in theory, lead to changes in fiscal patterns that are consistent with Wisconsin's recent experience.

The most important change in the external fiscal environment for local governments in Wisconsin has been the changing availability of intergovernmental revenue. Intergovernmental aid and tax credits for school districts--supplied principally by the state--increased rapidly through the 1980s.¹ Intergovernmental aid and tax credits for other local governments, particularly municipalities--supplied by the state and Federal governments--declined significantly.² Intergovernmental aid reduces the local cost of spending increases, and this shifting relationship of increased aid to school districts and decreased aid to other units of local government in Wisconsin has reduced the local cost of school spending increases and made spending increases for other local services more costly. Contemporaneous with this change in the local fiscal environment, local spending for education has increased while spending for other local services has remained constant.

In the sections to follow, more detailed exploration of trends in local revenues and expenditures in Wisconsin is pursued. Following an explication of Wisconsin's recent experience with local public finance, the report returns to a finer grain assessment of how changes in intergovernmental aid have been reflected in changes in local spending. Particular attention is drawn to how aid changes may help to account for the recent pattern of major increase in local school spending combined with little or no growth in spending by other local governments, and to the question of whether the changes are consistent with local fiscal accountability to informed citizens.

¹ Aid to school districts from Wisconsin's Department of Public Instruction and tax credits from state General Appropriations increased from \$998 million in 1983-84 to \$1,671 million in 1987-88. This is a nominal increase, measured in current dollars, of 67.5 percent and a real increase, discounted for inflation, of 42 percent. Source: *State of Wisconsin, Annual Fiscal Reports, 1984 and 1988*, Exhibit C-3.

² State aid and tax credits for local governments other than school districts increased by 3.3 percent from 1983-84 to 1987-88 after discounting for inflation (Source: *Ibid*). Total state and Federal intergovernmental aid to municipalities--cities, villages, and towns--declined by 17.4 percent, also discounted for inflation. Source: U.S. Bureau of the Census, *Governmental Finances in 1983-84 and Government Finances in 1987-88*.

Local Revenue Trends in Wisconsin

Total general revenues of Wisconsin's local governments in 1987-88 were \$8.7 billion.³ Revenues of school districts and Vocational, Technical & Adult Education (VTAE) Boards accounted for \$4 billion, or 45 percent, municipalities (cities and villages) and counties 24 percent each, and towns and other local governmental entities 3 percent each (Figure 2.1). Local revenues in current dollars were \$6.8 billion in 1984 and \$8.0 billion in 1986. In real dollars, discounting effects of price inflation, local revenues increased by 7.7 percent from 1984 to 1986, but by only 0.2 percent from 1986 to 1988.⁴ Real per capita revenues of local governments and revenues as a percent of personal income actually decreased from 1986 to 1988--real per capita revenues declined by 1.2 percent and local general revenues from 12.7 to 12.3 percent of personal income in the state.

Local Revenue Sources

Local governments in Wisconsin rely on intergovernmental aid for the largest single source of their revenues. The percent of local revenues supplied intergovernmentally declined slowly through the 1970s and 1980s, but remains high in comparison with other states--nearly 45 percent of local general revenues in 1988 were intergovernmental transfers.⁵ Next in importance, and growing in its share of local revenues, is the property tax--accounting for nearly 36 percent of local general revenues in 1988, up from a low of 30 percent in 1980-81. The third significant revenue source for local governments is user charges and miscellaneous revenues, which have grown from 6 percent of revenues in 1976 to nearly 15 percent by 1988.

The use of these revenue sources varies by type of local government (Figure 2.2). Cities and villages rely on intergovernmental transfers somewhat less than the local government average.⁶ Local school and VTAE

³ Source: U.S. Bureau of the Census, *Government Finances in 1987-88*, Table 29, p. 95. General revenue includes all revenue except that from liquor stores, insurance trusts, utilities, issuance of debt, liquidation of investments, or money received as agency and private trust transactions. The Census Bureau combines revenues and expenditures of elementary/secondary school districts and VTAE boards under the heading "school district", and cities and villages under the heading "municipal" in its reports. Percentages do not total 100 due to rounding. Revenues shown in the figure include inter-local transfers, resulting in a total greater than the \$8.7 billion sum of local general revenues cited in the text.

⁴ The price deflator used in this report, unless indicated otherwise, is the implicit price deflator for state and local purchases of goods and services, found in the *Survey of Current Business*, July issues.

⁵ Source: U.S. Bureau of the Census, *Government Finances, 1987-88*. Intergovernmental transfers cited here include those from the Federal government and the state. The Census Bureau includes funds originating with the Federal government but channeled through the state in its count of intergovernmental revenues from the state, thereby overestimating the state's own contribution by a small amount. As data published by the Census Bureau do not allow separation of Federal pass-through funds, they are included as state-source revenue in this report where Census data are cited.

⁶ Cities and villages have reduced their reliance on intergovernmental revenues as Federal funds provided directly to local governments and those channeled through the state declined dramatically through the middle 1980s. In real dollars, the combined decline from 1984 to 1988 was \$148 million for cities and villages and an additional \$20 million for towns. The real decline for cities, villages, and towns combined over these years was \$38 per capita--\$17 in direct Federal aid, and \$21 in state aid and Federal aid pass-throughs. Source: U.S. Bureau of the Census, *Governmental Finances in 1983-84 and Government Finances in 1987-88*.

FIGURE 2.1

Local General Revenue (\$ Millions) by Type of Local Government: 1987-88

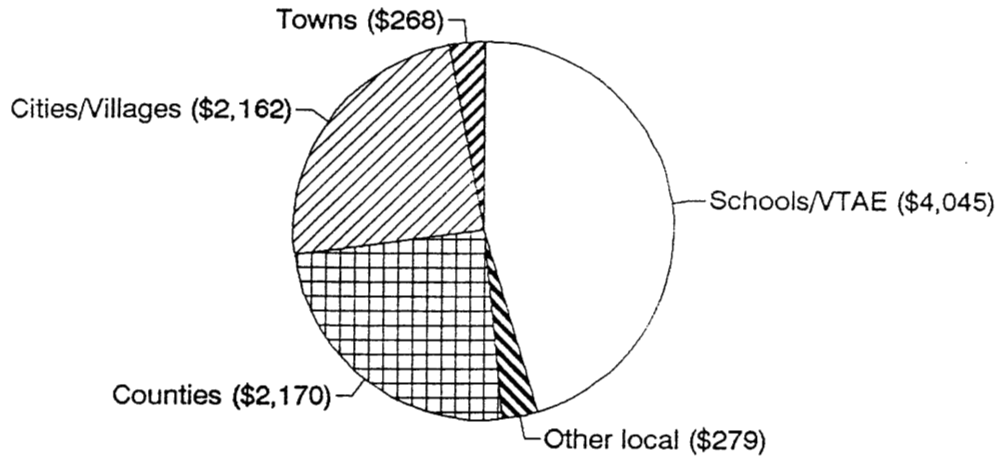
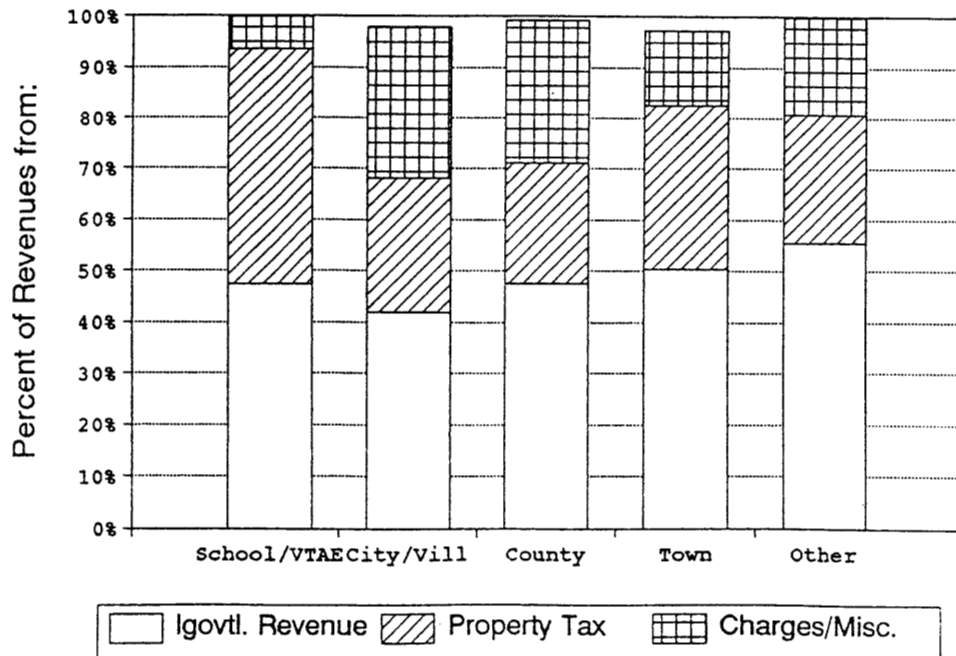


FIGURE 2.2

Sources of Local Revenues by Type of Local Government: 1987-88



districts collect a higher percentage of their revenues from the local property tax than do other units of local government⁷, and collect the largest share of this tax. It accounted for 46 percent of 1988 school/VTAE revenues, and these governmental units collected 60.2 percent of the local property tax in that year. Next most reliant on the property tax in 1988 were towns at 32.2 percent of revenues, followed by cities and villages--26.2 percent--and counties--23.4 percent. Property taxes collected by towns were only 2.8 percent of local property taxes, however. Cities and villages collected 18.3 percent of local property taxes in 1988, and counties, 16.4 percent.

Charges and miscellaneous revenues are most used by cities and villages--accounting for 29.8 percent of their revenues in 1988--and by counties--28.1 percent. Towns obtained 14.8 percent of their 1988 revenues from these sources, and school/VTAE districts made little use of charges or miscellaneous revenues--only 6.4 percent of their 1988 revenues came from them. State rules for the distribution of intergovernmental aid help to explain the preference of school districts for property taxes as the source of increased local revenues and the use of charges and fee increases in concert with property taxes by municipalities. "Aidable revenues" for municipalities and counties, i.e., local purpose revenues which are used in the computation of shared revenues obtained from the state, include non-tax receipts, user charges and fees.⁸ "Sharable costs" for school districts, i.e., local costs eligible for equalization aid from the state exclude costs paid for by non-tax receipts.⁹ Thus, for municipalities and counties as a group, the local "price" of a dollar of user charges or fees is less than one dollar by the amount of state aid it triggers, while for school districts as a group, user charges or fees are "priced" locally at their full nominal value.

Local Revenue Trends

Real general revenues of local governments relative to Wisconsin's population have been relatively stable since the middle 1970s--fluctuating in the range of \$1,300 to \$1,400 per capita--and have declined as a percent of personal income in the state from 14.8 in 1976 to 1988's 12.3 percent. Revenue trends of different types of local governments have been quite different, however (Figure 2.3). School/VTAE district revenues increased substantially, revenues of cities, villages, and towns as a group declined substantially, and real per capita revenues of counties declined in 1980 and 1981, remaining essentially constant since then.

In the early 1980s, a group of large dependent school districts changed to independent status. This explains the sharp rise in real per capita school/VTAE district revenues from 1982 to 1983, as the revenues of the dependent districts had been counted by the Census Bureau as municipal revenues prior to this change. The sharp decline in city, village, and town combined revenues between 1982 and 1983 also reflects this transfer. Per capita revenues of school/VTAE districts continued to grow after this change in accounting, however, increasing by 8 percent in real terms between 1984 and 1986, and by an additional 3.1 percent from 1986 to 1988. Municipal (here defined as cities and villages plus towns¹⁰) real revenues after 1984 have remained essentially constant in proportion to their population.

⁷ In 1988, school/VTAE district revenues from the property tax and from intergovernmental aid were nearly equal at \$1.86 billion from property taxes and \$1.91 billion in intergovernmental transfers. Source: U.S. Bureau of the Census, *Government Finances in 1987-88*.

⁸ Legislative Reference Bureau, State of Wisconsin, *A Legislative History of Shared Revenue in Wisconsin*, Research Bulletin 85-RB-1, January 1985, pp. 32-33.

⁹ Wisconsin Department of Public Instruction, *1987-88 Basic Facts About Wisconsin's Elementary and Secondary Schools*, Bulletin No. 8370, 1988, p. G-3.

¹⁰ This definition is necessary for use of statewide population data in conjunction with revenue and expenditure figures published by the Census Bureau.

FIGURE 2.3

General Revenue per Capita by Type of Local Government [\$1982]

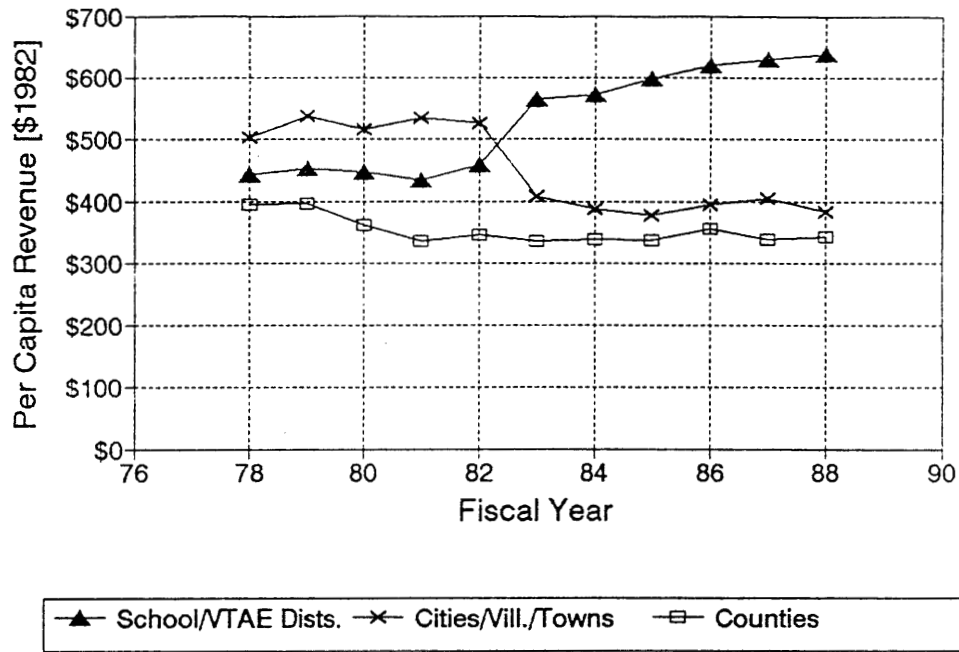
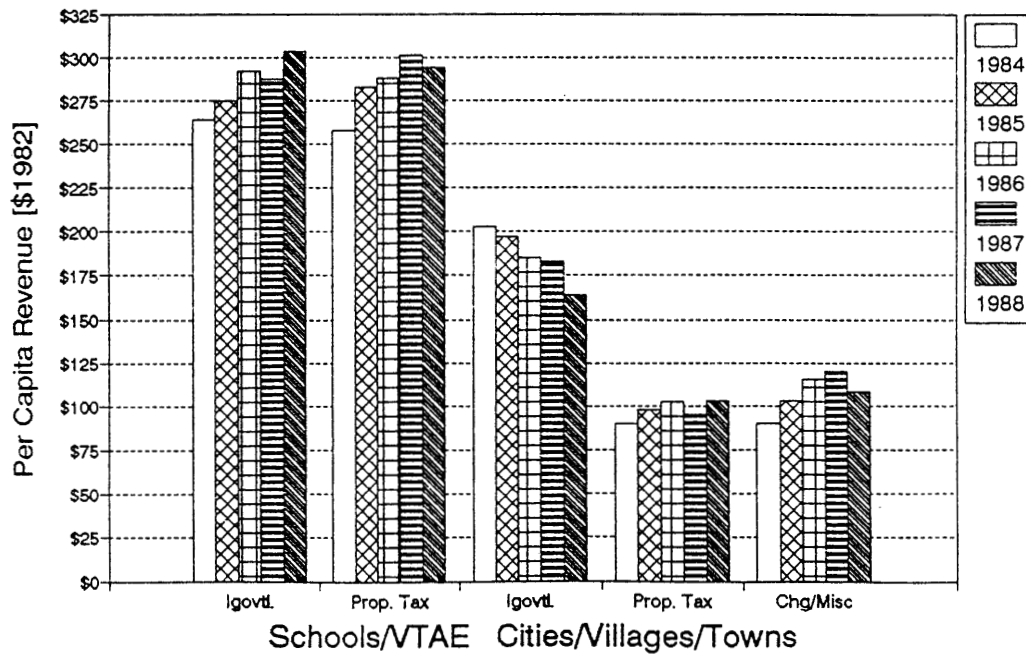


FIGURE 2.4

Real General Revenue per Capita Major Components 1984-88 [\$1982]



Comparison of the revenue growth experienced by school/VTAE districts to that of municipalities (cities, villages, and towns) in the period 1984 to 1988, after the transfer of dependent school districts to independent status, reveals a difference potentially relevant to consideration of local fiscal accountability. A significant share of revenue growth for school/VTAE districts in recent years has been increased intergovernmental aid--principally from the state (Figure 2.4). From 1984 to 1988, real intergovernmental revenues for school/VTAE districts grew by \$39 per capita. School/VTAE district property tax levies grew by \$36 per capita in deflated dollars over the same period, and revenues from charges and miscellaneous sources declined by \$10 per capita.¹¹ Thus, more than half of the real increase in school/VTAE district per capita revenues over this period was the result of state and, to a much lesser extent, Federal action, with less than half locally-generated. Put in somewhat different terms, a one dollar increase in local education revenues statewide between 1984 and 1988 resulted in a direct cost locally of 40 cents.¹² Of course the remainder of the increase was paid by state taxpayers too, but as it was financed through taxes collected by the state, a degree of "fiscal illusion" may be introduced, with local citizens not all recognizing that increases in their state taxes reflected in part increased spending by local school/VTAE districts.

Municipalities (cities, villages, and towns) exhibited a different pattern of revenue change. Their combined per capita revenues declined by \$5 in real terms from 1984 to 1988, with a \$38 drop in intergovernmental revenues--principally the result of the decrease in Federal funds for local governments. This decrease in intergovernmental aid to municipalities was nearly offset by real increases in local property taxes (\$13 per capita), and in charges and miscellaneous revenues (\$18 per capita). This change in the sources and amounts of real revenues as between school/VTAE districts and municipalities may be indicative of real differences in local fiscal accountability, as school/VTAE districts have been able to garner significant revenue increases from intergovernmental (state) sources in parallel with increases in their property tax revenues,¹³ while municipalities have had to offset declines in intergovernmental aid with funds raised locally. To the extent that increases in revenues generated locally require officials to be more accountable to local voters than do revenue increases from intergovernmental sources, local fiscal accountability may be higher in municipalities than in school/VTAE districts. To the extent that Wisconsin's revenue system contributes to greater fiscal illusion in the financing of local school/VTAE districts than in the financing of municipalities and counties, it is not surprising that school/VTAE district revenues have increased more rapidly than those of the latter governmental units.

¹¹ Source: U.S. Bureau of the Census, *Governmental Finances in 1983-84*, and *Government Finances in 1987-88*.

¹² The ratio of a \$26 per capita increase in own source general revenue to the \$65 per capita increase in total general revenue.

¹³ A parallelism which results from the state equalization aid formula as it applies to most school districts. See the discussion of state aid for school districts below.

Local Expenditure Trends in Wisconsin

Total direct general expenditures of Wisconsin's local governments in 1987-88 were \$9.1 billion, 63 percent of all state/local general spending in the state. Of this total, school/VTAE districts accounted for 47 percent, municipalities (cities and villages) 23 percent, counties 24 percent, and towns and other local governmental entities 3 percent each (Figure 2.5).¹⁴ Local general expenditures in current dollars were \$7.0 billion in 1984 and \$7.9 billion in 1986. In real dollars, discounting price inflation, local general expenditures increased by 4.6 percent from 1984 to 1986, and by 5.6 percent from 1986 to 1988. Real per capita general expenditures of local governments increased by 8.4 percent from 1984 to 1988--by \$112 in real dollars per capita--and expenditures relative to personal income in the state declined between 1984 and 1986, but increased back to approximately the 1984 level by 1988 at 12.8 percent of personal income.

As with revenues, the pattern of increases in real general expenditures per capita was mixed. School/VTAE districts increased their real per capita spending by 16 percent from 1984 to 1988, municipal spending (by cities, villages, and towns) declined slightly relative to population in real dollars (-2.8 percent), and county spending increased by 6 percent.

Local Expenditures by Object

Education spending accounted for nearly one-half of local general expenditures in 1988 (Figure 2.6). At the local level, education was virtually the sole responsibility of school/VTAE districts by 1988, as dependent (city) school districts were transferred to independent status earlier in the decade and counties spent less than one percent of the education total. Local public welfare, health, and hospital spending combined was about one eighth of total local spending, with the bulk of this expended by counties. Local spending for highways was 8.6 percent of the total, with cities and villages accounting for 45 percent of local highway spending, counties 37 percent, and towns, for which highway spending is the largest local expenditure, 18 percent. Police and fire expenditures were just over 8 percent of the local spending total, with cities and villages accounting for nearly 80 percent of these service expenditures. Interest on local debt is a small portion of local spending in Wisconsin--3.4 percent of total local spending in 1988. Cities and villages paid more than one-half of local interest charges in that year.

Local Expenditure Trends

The only significant category of Wisconsin's local spending where real increases occurred in recent years is public education, where real per capita spending increased by about 16 percent from 1984 to 1988 (Figure 2.7). Local increases in public welfare spending were matched by declines in local spending for health and hospitals. Highway spending, spending for police and fire services, and for all other spending categories combined exhibited virtually no real change since 1983. The \$92 per capita increase in real local spending for education between 1984 and 1988 was fully 82 percent of all spending growth at the local level over these years.

¹⁴ Source: U.S. Bureau of the Census, *Government Finances in 1987-88*. Direct general expenditure includes all expenditure other than that for liquor stores, insurance trusts, utilities, transfers to other units of government, retirement of debt, investment in securities, extension of credit, or as agency transactions. Dollars included in direct general expenditure explicitly include those obtained from the issuance of debt, thus differing by this inclusion from general revenue discussed above. Percentages do not total 100 due to rounding.

FIGURE 2.5

Direct General Expenditure (\$ Millions)
by Type of Local Government: 1987-88

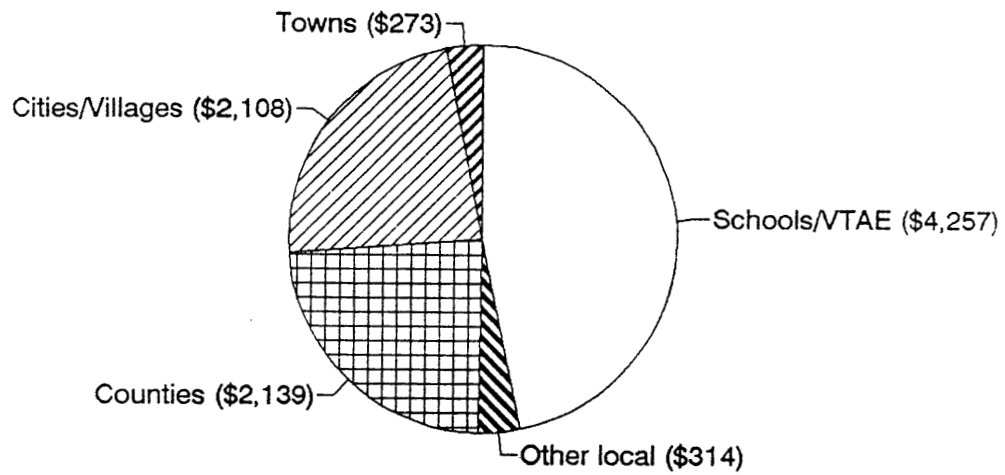


FIGURE 2.6

Direct General Expenditure by Object
1987-88

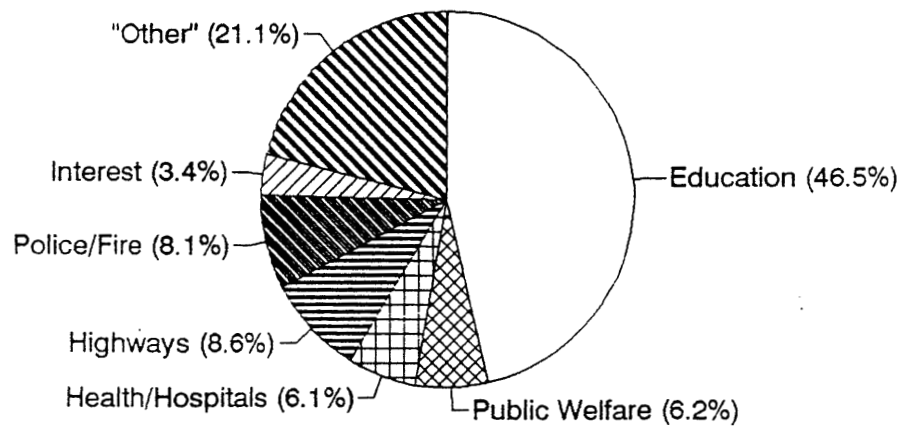
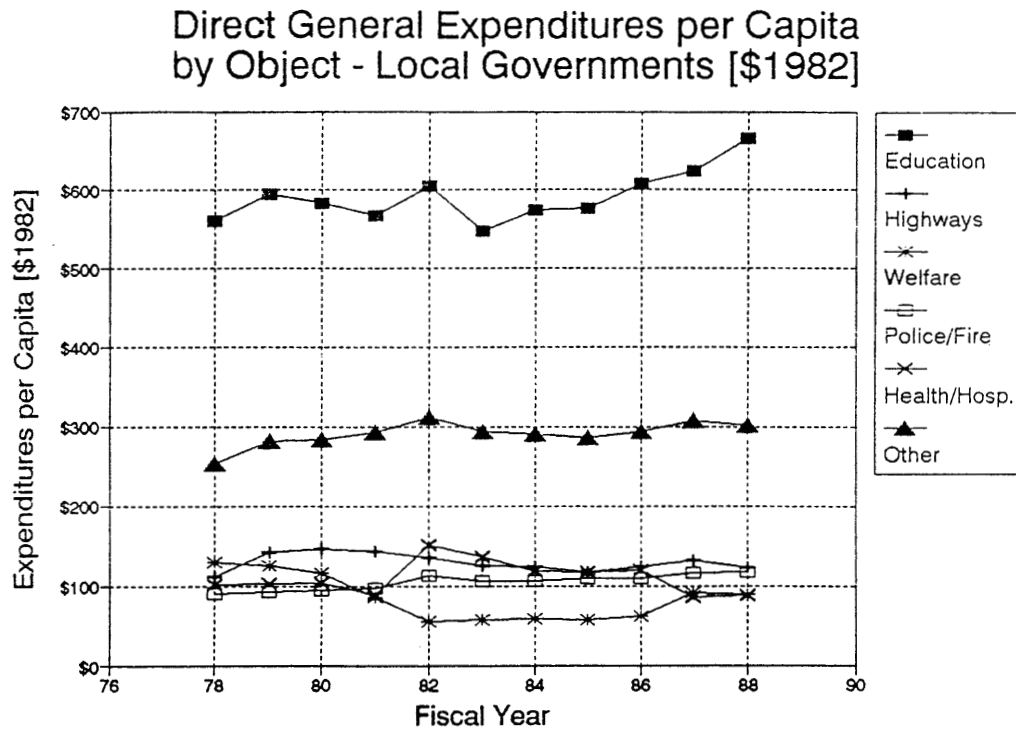


FIGURE 2.7



In all local spending categories excepting education, the goal of the 1986 Wisconsin Expenditure Commission to bring Wisconsin's expenditures as a percent of personal income in the state down to the national average by 1992-93 appears achievable, as spending growth in these categories has tracked generally below the Commission's target of 3.8 to 4.6 percent annual increase.¹⁵ However, as education expenditures have increased at a relatively rapid pace, with education accounting for the largest block of local spending, it may be that the Commission's goal will not be achieved by its target date. This observation is not an endorsement of the Commission's target, however. That is a matter for Wisconsin's citizens to decide. Rather, it is intended to draw attention to the difference in expenditure trends as between local education and other local services as a matter requiring exploration--an exploration which is the subject of the following section of this report.

¹⁵ Wisconsin Expenditure Commission, *Final Report*, December 1986, p. 22.

Explaining Local Fiscal Trends: Intergovernmental Aid and State Rules

Spending for Elementary and Secondary Education

During the period 1981-82 to 1987-88, spending for elementary and secondary schools in Wisconsin jumped from \$2.26 billion to \$3.82 billion, a nominal increase of 69 percent, and a real (deflated) increase of 30 percent.¹⁶ State aid for local school districts--including Federal fund pass-throughs--increased from \$892 million to \$1.79 billion in these years, accounting for 57.6 percent of the local spending increase.¹⁷ Current dollar spending per pupil enrolled in elementary and secondary schools increased from \$2,811 to \$4,943--by 76 percent--or by 35 percent when adjusted for inflation.¹⁸

In the 1980s, total student enrollment in Wisconsin's local public schools declined through the 1984-85 school year and increased slightly since then. Enrollment in 1987-88, 772,363 students, was about 4 percent lower than enrollment in 1981-82, and the number of high school graduates was 13 percent lower. The number of teachers (FTE) employed by Wisconsin's public schools declined slightly over this period--leaving pupil/teacher ratios approximately constant--as did the number of non-professional support staff. Professional staff other than teachers increased in these years, but constitute a relatively small portion of total staff--just under 10 percent in 1987-88.¹⁹ In general, then, the increase in spending for education at the local level cannot be explained by increases in the student population served nor by significant increases in the staff providing them with educational services. Rather, it represents a large, real increase in the cost of public instruction.²⁰

¹⁶ Source: U.S. Bureau of the Census, *Governmental Finances in 1981-82 and Government Finances in 1987-88*.

¹⁷ Source: State of Wisconsin, *Annual Fiscal Reports for the Years Ending June 30, 1982 and June 30, 1988*, Exhibit C-3.

¹⁸ Expenditures from U.S. Bureau of the Census, *Governmental Finances in 1981-82 and Government Finances in 1987-88*. Enrollments from Wisconsin Department of Public Instruction, *Basic Facts About Wisconsin's Elementary and Secondary Schools, 1983-84 and 1987-88*.

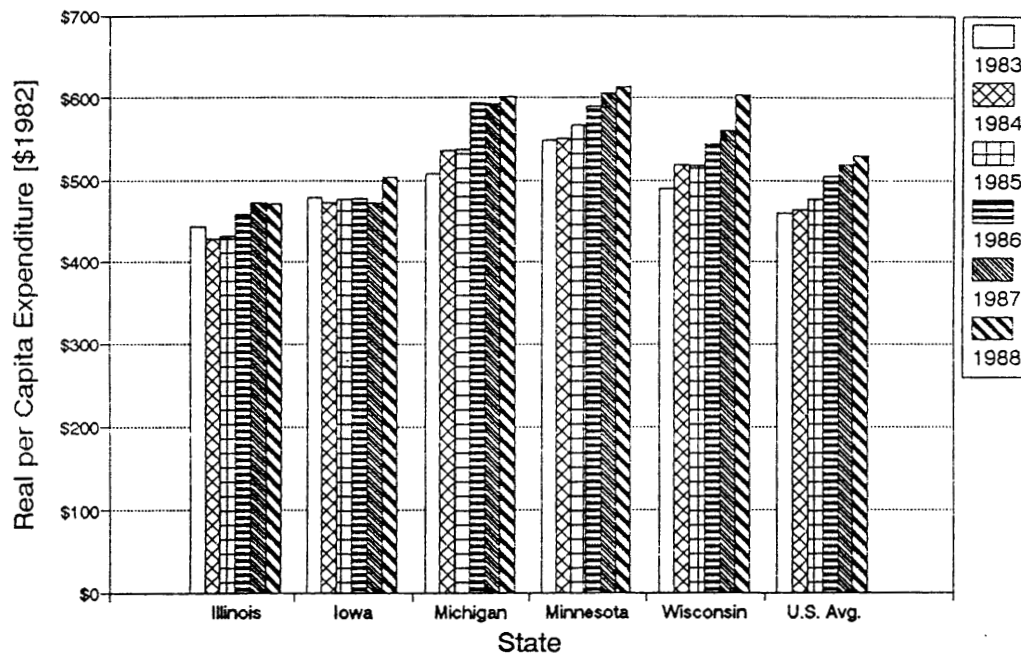
¹⁹ Data in this paragraph are from *Basic Facts About Wisconsin's Elementary and Secondary Schools*, Wisconsin Department of Public Instruction, various years, and (for high school graduates) U.S. Department of Education, Center for Education Statistics, "Common Core of Data" survey.

²⁰ One component of this cost increase is significant salary increases for teachers in public elementary and secondary schools. In 1981-82 average teacher salaries in Wisconsin were about the same as average salaries nationwide. Measured in constant dollars, national average teacher salaries grew by 16.5 percent through 1986-87. In Wisconsin, average teacher salaries increased by 22.1 percent over the same years. As a result Wisconsin's teachers salaries were more than 5 percent higher than the national average in 1986-87. Source: National Education Association, *Estimates of School Statistics*. See also State of Wisconsin, Legislative Audit Bureau, *Informational Memorandum 88-3*, "The Effect of Salary and Fringe Benefit Increases on Local School Spending".

A 1985 analysis conducted by the Wisconsin Legislative Council Staff concluded that Wisconsin's Mediation-Arbitration Law had a significant positive impact on wages for school unit employees, and the data reported here are consistent with the possibility of continued positive impact post-1985. See *Staff Brief 85-8G*, "Impact of the Mediation-Arbitration Process on Wages of Municipal Employees", p. 27.

FIGURE 2.8

Elementary/Secondary School Expenditure Wisconsin Neighbors and U.S. Average



Wisconsin was not the only state to experience a significant increase in spending for local public schools during the 1980s, but the increase in Wisconsin substantially exceeded the national average. Per capita spending for elementary and secondary education nationally increased by \$231 from 1982 to 1988--a 50 percent nominal increase and a 15 percent increase after discounting inflation. The comparable increase in Wisconsin was \$310 per capita, 65 percent in nominal and 27 percent in real dollars. As a percent of personal income, elementary and secondary education spending nationwide remained approximately the same in 1988 (4.5 percent) as in 1982 (4.4 percent). In Wisconsin, elementary and secondary school spending increased from 4.6 to 5.4 percent of income.²¹ Between 1982 and 1988, Wisconsin moved from eighteenth to sixth among the 50 states in per capita spending for elementary and secondary education, and from twentieth to eleventh in spending as a percent of personal income. Wisconsin's percentage increase in real per capita spending was ninth highest in the nation, and its increase in spending relative to personal income was fourth highest nationwide. In this six year period, Wisconsin's per capita spending caught up with its neighbors, Michigan and Minnesota (Figure 2.8)--both of which have been among the top states in local public school spending for a number of years--and passed them in spending as a percent of personal income.

State Equalization Aid for Wisconsin's Public Schools

As noted above, state aid for local schools in Wisconsin increased significantly during the 1980s. During the same period, however, local property taxes for public education increased along with increases in intergovernmental aid. These parallel increases are intertwined as a result of the state's formula for

²¹ Source: U.S. Bureau of the Census, *Governmental Finances in 1981-82* and *Government Finances in 1978-88*.

distribution of general equalization aid to local school districts. In order to gain its maximum increase in state equalization aid dollars, an average district must increase its spending in proportion to the increase in state aid available. To see how this works it is necessary to examine the formula for General Equalization Aids, and to explore the incentives this formula provides.

General state aid for school districts in Wisconsin is designed to equalize the property tax base for operational and debt service costs of school districts, following "a general rule that districts which spend at the same level per member will tax at the same rate."²² General state aid for equalization purposes has "primary" and "secondary" components, which operate together to implement this general rule. The primary component employs the following formula for determining aid:

$$\text{General State Aid} = \text{Shared Cost} \times \frac{\text{Net Guaranteed Valuation}}{\text{Primary Guaranteed Valuation}}$$

"Shared cost" is defined by statute as:

...the sum of the net cost of the general fund and the net cost of the debt service fund. The net cost of the debt service fund included in the shared cost may not exceed an amount equal to \$90 multiplied by the membership.

"Membership" is a measure of student enrollments in regular and summer school sessions. "Primary guaranteed valuation" is a guaranteed tax base per member which is established by statute at a level which exceeds the actual tax base per member of most districts in the state. "Net guaranteed valuation" is the difference between the state guaranteed valuation per member and a district's actual equalized valuation per member.

If a district's shared cost does not exceed a specified value, the "primary cost ceiling", and if its actual valuation per member falls below the statewide primary guaranteed valuation--contingencies which are true for most districts in the state--then general state aid will be made available to the district as specified in the formula above.²³ The proportion of shared costs paid by the state in this circumstance is equal to one minus the ratio of the district's actual valuation per member to the statewide guaranteed valuation--the lower a district's actual valuation, the higher the proportion of its shared cost that is paid by the state. In other words, the "price" of a dollar of shared cost to taxpayers in a district--equal to the ratio of the district's actual valuation to the state guaranteed valuation--is less than one dollar by virtue of the equalization aid.

The "secondary" component of state equalization aid comes into play for districts whose shared cost per member exceeds the primary cost ceiling. It applies to the amount of shared costs exceeding this ceiling and is distributed by the following formula:

$$\text{Secondary Aid} = \text{Secondary Cost} \times \frac{\text{Secondary Net Guaranteed Valuation}}{\text{Secondary Guarantee}}$$

²² Wisconsin Department of Public Instruction, *Basic Facts About Wisconsin's Elementary and Secondary Schools*, 1987-88. The description of the aid formulae below relies heavily on this publication.

²³ If a district's valuation exceeds the statewide guaranteed level, no equalization aid is forthcoming directly, although there are provisions for minimum aids and special adjustment aids that can result in aid payments to high value districts, and those districts remain eligible for a variety of additional categorical, supplemental, and integration aids.

where "secondary cost" is the amount by which a district's shared cost exceeds the primary cost ceiling, the "secondary guarantee" is equal to 106% of the state-average equalization per pupil, and the "secondary net guaranteed valuation" is the difference between the secondary guarantee and the district's actual valuation per member. The secondary aid formula, unlike that for primary aid, can result in a negative value which, if it occurs, is subtracted from the primary aid available to the district. In no case, however, can a district receive negative total--primary plus secondary--aid.

State Aid as a Contributor to Increased School Spending

The application of these formulae would seem to achieve substantially the goal of equalizing tax bases for shared costs among public school districts in Wisconsin. There are a few districts with actual valuations so high that they are able to support higher shared costs with no equalization aid and a relatively low tax rate, but their numbers are small.²⁴ There are aspects of the formulae, however, that most likely contribute to school cost escalation in the pursuit of equalization.

First, the guaranteed valuation for primary shared costs is set well above the statewide average valuation per member. This is done consciously, in pursuit of the state's avowed goal of raising the state's share of shared costs to equal 50%.²⁵ Second, the primary cost ceiling is set at a level of 110% of the previous year's state average shared cost per pupil, thus containing a built-in, and generous inflation factor. Third, the secondary guarantee is set at 106% of the state-average equalized valuation per pupil, also affording an inflation factor larger than recent U.S. experience. If local school costs remained constant in real terms, i.e., if nominal expenditures grew in proportion to inflation and increased enrollments (if any), the state would quickly reach its 50% goal and achieve tax base equalization across all but a few wealthy districts.

From the point of view of local school districts, however, state aid not only contributes to tax base equalization, but may also provide incentives to increase spending or, to phrase it somewhat differently, aid may reduce incentives for local school officials to control costs as diligently as they might if cost increases were all borne locally. Assume, as is the case for most districts, that a local district's actual equalized valuation is below the primary guaranteed valuation per member. For such a district, a dollar of increased expenditure requires less than a dollar in increased taxes to be imposed directly on district taxpayers.

Consider, as an example, a K-12 district with equalized valuation per member of \$164,432--the statewide average equalized valuation per member for K-12 districts--and school costs eligible for sharing at or below the primary cost ceiling of \$3,860 per member.²⁶ The primary aid formula applied to this district would be:

$$\text{State Aid} = \text{Shared Cost} \times (1 - 164,432/288,114),$$

where \$288,114 is the primary guaranteed valuation for K-12 districts. The part of the formula in parentheses yields a value of 0.43. This means that for each dollar increase in district spending for

²⁴ In 1987-88, only 39 of the state's 431 districts were estimated to be eligible for no general school aid. Source: Wisconsin Department of Public Instruction, *Basic Facts About Wisconsin's Elementary and Secondary Schools, 1987-88*, Section E.

²⁵ See, for example, Governor Thompson's *Executive Budget, January 1987*, p. 399.

²⁶ The statewide average equalized valuation per member is computed from the Secondary Guaranteed Valuation divided by 1.06--the factor by which the secondary guarantee exceeds the statewide average. The values of the primary and secondary guarantees and the primary cost ceiling are taken from Wisconsin Department of Public Instruction, *Basic Facts About Wisconsin's Elementary and Secondary Schools, 1987-88*, p. E-1.

education, the direct cost to local taxpayers would be but 57 cents--43 cents of each dollar spending increase would come to the district in state equalization aid.

The formula, by keying increased state aid to increased local spending, can induce local spending increases beyond those needed to hold real spending at the same level from year to year. Suppose that the example K-12 district had spent at the primary cost ceiling in 1986-87, \$3,528 per member in costs eligible for state sharing. Price inflation for state and local purchases of goods and services was just over 5 percent from 1987 to 1988.²⁷ If the district's spending increased by this rate of inflation, its sharable cost in 1987-88 would be \$3,707, below the primary cost ceiling of \$3,860. Its state equalization aid would be \$1,594 per member ($0.43 \times \$3,707$). If, however, the district increased its spending by the same percentage as the increase in the primary cost ceiling, to \$3,860, it would be entitled to \$1,660 per member in state equalization aid--an additional \$66 per member. In other words, the district could increase its spending by \$153 per member more than the increase required to keep real spending at the same level as the previous year by raising local taxes \$87 per member. If it did so, school spending would increase by 9.4 percent in nominal dollars, or a real cost increase of 4.3 percent after subtracting the rate of price inflation. Perhaps not by coincidence, then, real school spending in Wisconsin has increased at an average rate of roughly 4 percent above that needed to offset price inflation per year since 1984.

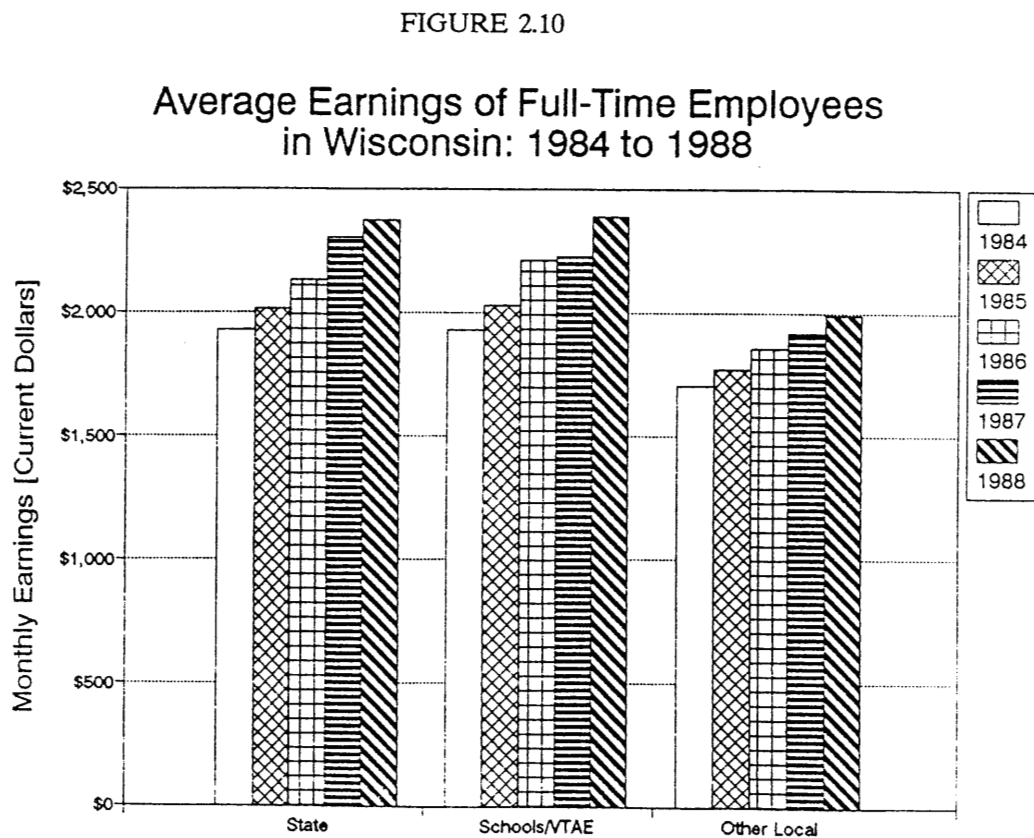
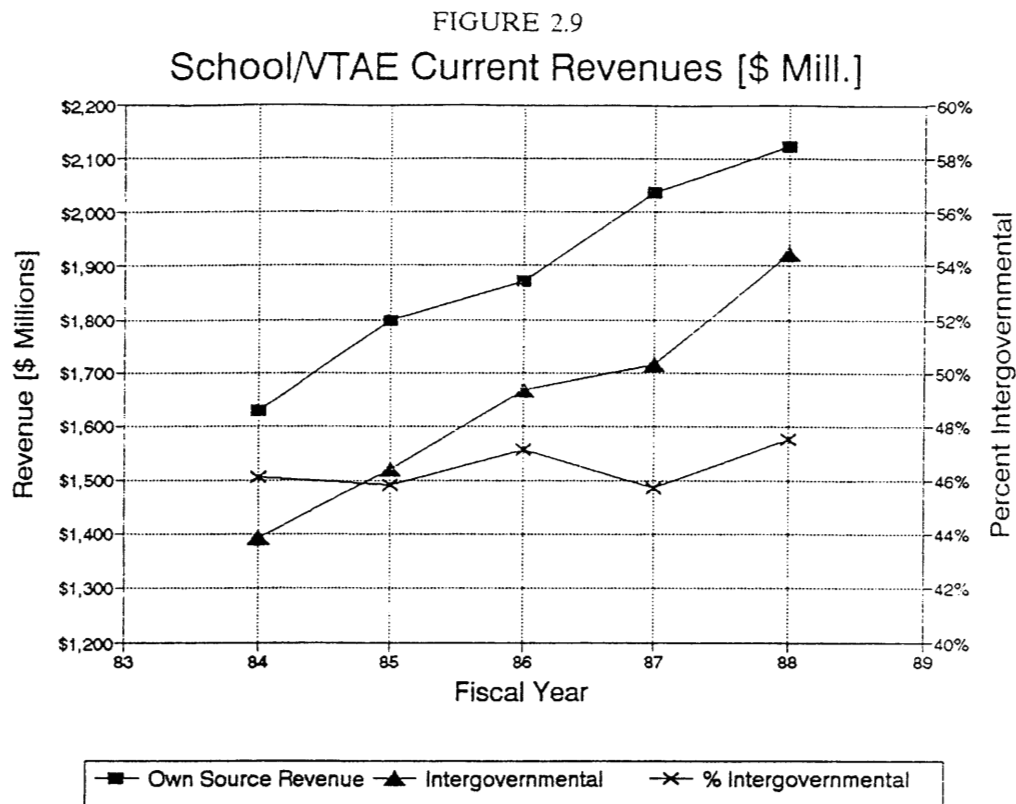
State government's attempt to reach a goal of 50 percent funding for local education, by virtue of the aid formula employed, has put the state in the position of pursuing a moving, ever increasing target. From 1984 to 1988, combined school/VTAE district own source revenues increased from \$1.63 billion to \$2.12 billion--30.2 percent in current dollars and 10.5 percent in dollars deflated for price inflation.²⁸ Over the same years, intergovernmental aid--principally state aid--for school/VTAE districts increased from \$1.39 billion to \$1.92 billion--37.9 percent in current dollars and 17 percent in deflated dollars (Figure 2.9). Intergovernmental aid grew faster than own source revenues in absolute dollars and increased as a percent of general revenues, but the substantial increase in own source revenues meant that the state did not reach its goal of 50 percent funding for local education. Aid represented 46.1 percent of school/VTAE district general revenues in 1984, and 47.5 percent in 1988. As long as local education districts are able to increase their spending with a guarantee that state aid will increase apace--thereby reducing the amount of cost increase which directly impacts local taxpayers--it will be difficult to attain a goal of 50 percent funding for local education by the state.

Relative Price Effects of State Aid to Local Governments

The effect of Wisconsin's aid allocations and formulae on local public finance in recent years has been to reduce the perceived "price" of public education--the local tax increase that citizens are likely to associate directly with increased school spending--below that of alternative purchases of goods and services. Assuming a rational response of school district "consumers" to this lower perceived price, they will have an incentive to "purchase" relatively more public education than they would if they viewed themselves paying full price, and concomitantly, to purchase less of services where state aid either does not affect their perception of price, or lowers it less than it lowers the price of public education. In the face of such an incentive, one would expect to see an increasing portion of local spending devoted to public education as compared to other public goods and services, precisely the pattern that Wisconsin has exhibited over the past several years.

²⁷ Source: Bureau of Labor Statistics, *Handbook of Labor Statistics*, August 1989.

²⁸ Source: U.S. Bureau of the Census, *Governmental Finances in 1983-84 and Government Finances in 1987-88*.



An indication of this relative price effect can be drawn by examination of changes in the monthly earnings of full-time public employees in Wisconsin. Between 1984 and 1988, the average monthly earnings of full-time employees of school and VTAE districts increased by \$458--from \$1,926 to \$2,384, or by nearly 24 percent in nominal dollars and 8.7 percent in dollars adjusted for increases in the Consumer Price Index.²⁹ This increase was roughly comparable to the increase enjoyed by state employees over the same period (Figure 2.10). Average monthly earnings of employees of local governments other than school/VTAE districts, on the other hand, grew by \$281 in these four years, a nominal increase of 16.5 percent and a real one of but 2.3 percent. During this same period, full-time employment of school/VTAE districts grew by 2,480 persons and that of other local governments declined by nearly the same number, 2,282 persons.

These changes in earnings and employment are consistent with the argument presented above. Local public education has grown in its share of local public finance and employment in Wisconsin--and other local public services have declined by these measures--as the relative price in increased local taxes of education has been reduced by intergovernmental aid increases and the relative local price of other services has grown with aid decreases. A local school official in Wisconsin, when confronted with requests for spending increases by school administrators or with requests for higher salaries and benefits by school employees, may more readily accede to such requests if comforted by the knowledge that taxpayers statewide will pay a significant share of any increase, thus reducing the amount he or she must secure in increased local taxes. A municipal official in Wisconsin, on the other hand, is most likely searching already for increased local revenues to maintain current service levels in the face of intergovernmental aid declines. His or her willingness to entertain requests for real spending increases must be tempered by the realization that revenues to support any increase must also be solicited in major part from local constituents.

School Cost Increases--Intended or Unintended Consequences

The preceding discussion has attempted to show how Wisconsin's recent increases in spending for local schools reflects a reasonable response by local school officials to the incentives afforded them by state aid allocations and aid formulae. What cannot be determined from such analyses, however, is whether the rapid increase in local spending--and local school taxes--is an intended or unintended consequence of public policy decisions in the state.

The spending increase may be intended. A commitment to relatively high levels of spending for public education has been a feature of Wisconsin's fiscal practice for many years.³⁰ When a sample of Wisconsin citizens were asked in 1988, "do you think we spend too much, too little, or just about the right amount on public schools, both primary and secondary?", only 20 percent responded "too much", with 33 percent of those having an opinion saying "too little" and 40 percent indicating that spending was "just about the right amount".³¹ Eighty-three percent of those surveyed said that public education was "critically important" or "very important" when "compared to other issues", 70 percent thought that "the quality of public education" in their communities was "excellent" or "good", and 67 percent said they would "favor higher salaries to attract better teachers".³² These responses indicate substantial support for local public education

²⁹ Source: U.S. Bureau of the Census, *Public Employment in 1988*, and previous years.

³⁰ See, for example, The Wisconsin Expenditure Commission, *Final Report*, December 1986, especially the "Minority Statement of Chairman Gilbert W. Church", pp. 76-79.

³¹ Source: Wisconsin Policy Research Institute Report, *The Wisconsin Citizen Survey: A Survey of Wisconsin Public Opinion*, February 1988, question 15.

³² Source: *Ibid.*, questions 10, 11, and 25.

in Wisconsin and, further, support a contention that school spending increases in recent years may have been intended consequences of policy choices made in response to citizen preferences.

However, the survey supports the alternative interpretation--that of spending increases as unintended consequences--as well. Fifty-one percent of those surveyed said that they "oppose higher taxes to support public education in (their) community" and a plurality of 49 percent reported themselves "most opposed" to the local property tax among Wisconsin's major taxes.³³ In spite of this expressed opposition, however, property taxes for local school purposes have increased significantly in recent years. Further, there is no guarantee that increased spending for education, in and of itself, automatically translates into greater quality of education.

These mixed signals from the public are consistent with the possibility of fiscal illusion discussed earlier. Wisconsin residents value local public education highly and indicate a willingness to pay more for better teachers in their public school (a willingness reflected in the substantial salary increases that Wisconsin school teachers have achieved during the 1980s). At the same time they oppose higher taxes for public education, and single out the local property tax as the tax they find most offensive. Taken together, these responses suggest that citizens of Wisconsin may not be fully cognizant of the dynamic induced by the state equalization aid formulae. Higher salaries to attract better teachers, which two-thirds favor, and more spending for local public schools, which is preferred over less spending by a 3 to 2 ratio, require an increase in local property taxes in and of themselves, which a majority say they oppose, and to trigger increased aid from the state--and a majority think that the state spends "too much" already.³⁴

Reducing fiscal illusion, thus enhancing local fiscal accountability, requires attention to fiscal mechanisms that provide citizens with full information about the consequences of their expressed preferences. With full information, citizens are in a position to weigh the relative costs and benefits of proposals for increased (or decreased) spending, whether for local schools or for other local public services. In recent years, a number of states have experimented with a variety of mechanisms designed to increase fiscal accountability at local and state levels. The states' experiences with several such experiments, and the lessons they may have for enhancing accountability in Wisconsin are the subject of the next chapter.

³³ Source: Ibid., questions 26 and 56.

³⁴ Source: Ibid., question 6.

TAX AND EXPENDITURE LIMITATIONS

The U.S. Experience

The most recent and most serious "Tax Revolt" is dated by convention to 1978, with the passage of Proposition 13 in California and the adoption of taxing and spending limitations in a number of other states. Not all limitations were adopted in 1978--Massachusetts' Proposition 2 1/2 and Missouri's Hancock Amendment, for example, occurred two years later--but 1978 is viewed as a watershed year, when voters in many states indicated that state and local government had grown big enough or even too big.

The variety of tax and expenditure limitations (TELS) adopted by states during the tax revolt is quite wide in detail. At a relatively abstract level, however, one can sort the variety into two types. The first, exemplified best by the California and Massachusetts initiatives, mandated significant real cuts in taxing, total revenues, or spending, reducing the base from which future growth, if any, might occur. The second, much more common variety, did not require immediate cuts in revenues or spending, but rather focused on limiting growth, differing across the states in the index used to constrain future growth. TELS implemented by the states during the last ten years also varied in their targets. Twenty-one states adopted TELS that, by one means or another, imposed limits on state government itself.¹ States were much more willing to limit their local governments, however. Forty-one states imposed one or more forms of taxing or spending limitation on their city and county governments during this period.²

Examining the 50 states' experience in the ten years following the onset of the Tax Revolt, one has to conclude overall that--if the intent was to halt government growth at state and local levels--the effects were modest, at best characterized as moderating the rate of increase in government rather than halting it. In the following discussion, we explore revenue and expenditure effects. Because of the differences in functional responsibilities between state and local governments across the 50 states, it is not possible to examine state and local effects separately. We, therefore, focus on combined state/local revenues and, subsequently, state/local expenditures for purposes of comparison.

Revenue Effects

Consider first the change in combined state/local tax revenues over this period. In 39 of the 50 states, state and local tax revenues in 1988 were lower as a fraction of personal income than they were in 1978. In two states--the most-cited "revolt" states of California and Massachusetts--state and local tax revenues relative

¹ These were Alaska, Arizona, California, Colorado, Delaware, Hawaii, Idaho, Louisiana, Massachusetts, Michigan, Missouri, Montana, Nevada, New Jersey, New Mexico, Oregon, Rhode Island, South Carolina, Tennessee, Texas, and Washington. Source: Council of State Governments, *Book of the States: 1982-83*, Vol. 24, pp. 417-22, and Marcia A. Howard, "State Tax and Expenditure Limitations: There is No Story", *Public Budgeting & Finance*, 19 (Summer 1989), pp. 83-90. The lists provided by these two sources were merged and Utah, which never implemented its state TEL was dropped. Details of the TEL mechanism in each state may be found in *Book of the States*.

² The states with no restriction on local governments are Connecticut, Georgia, Maine, New Hampshire, South Carolina, Vermont, and Wisconsin. Hawaii and Virginia, both of which have weak full-disclosure limits are included as providing essentially no limit. Source: Steven D. Gold and Martha A. Fabricius, *How States Limit City and County Property Taxes and Spending*, Legislative Finance Paper #67, Denver, Colorado: National Conference of State Legislatures, March 1989.

to personal income were substantially lower than their 1978 levels.³ But declines relative to personal income do not necessarily imply declines in the size of government if--as occurred during these years--personal incomes in the states grow rapidly. In fact, only four states experienced real declines in per capita tax revenues from 1978 to 1988.⁴

Further, most states increased their use of non-tax revenues during this period, offsetting declines in Federal aid and, in a number of states, declines in tax revenues. Table 3.1 shows state-by state changes in per capita own source revenues that occurred between 1978 and 1988--indexing those changes by the difference between each state's actual per capita revenues in 1988 and what its revenues would have been if a) revenues relative to personal income had remained constant or b) revenue growth had been limited to the increase in state population and price inflation. The first column in the table shows that only 19 of the 50 states had own source state/local revenues relative to personal income in 1988 that were lower than their 1978 values.⁵ Every state experienced real growth in own source state/local revenues relative to population between 1978 and 1988, as shown by the values in column three of the table, and the nationwide increase in real dollars per capita was 21 percent.⁶

A better test of TEL effects is afforded by contrasting the experience of states that adopted TELs to the experience of states that did not. Recall from above that 21 states imposed limits on state government and 41 states on local governments between 1978 and 1988. Examining revenue growth in states that did or did not adopt state or local TELs provides additional evidence of limited effects.

³ Source: U.S. Bureau of the Census, *Governmental Finances in 1977-78* and *Government Finances in 1987-88*. Following their tax revolts, California and Massachusetts dropped from among the top-ranked states in taxes as a percent of personal income to about mid-range among the 50 states.

⁴ The states were California, Idaho, Nevada, and West Virginia. "Real decline" is the change in nominal revenues discounted for the effect of price inflation by the implicit price deflator for state and local purchases of goods and services found in the *Survey of Current Business*, July issues, and refers to changes that, after discounting the effect of price inflation, yielded lower per capita tax revenues in 1988 than in 1978.

⁵ For example, in 1988 California had per capita own source revenues that were \$420 below what they would have been had the state's revenues been the same percent of the state's aggregate personal income in 1978. Actual state/local own source revenues in California in 1988 were \$2,803 per capita--16.1 percent of personal income. Had they been the same percent of income as in 1978--18.5 percent--own source revenues would have been \$3,223 per capita.

⁶ The fourth column in the table shows each state's percentage increase in own source revenues discounted for population growth and price inflation.

TABLE 3.1

Difference in Actual Per Capita Own Source Revenues in 1988 Relative to (A) Growth in Personal Income or (B) Growth in Population and Inflation from 1978 to 1988.

State	Difference Relative to Growth in Personal Income		Difference Relative to Growth in Population and Inflation	
	[+/- \$1988]	[%]	[+/- \$1988]	[%]
AK	7,351	70.3	5,222	99.7
AL	107	6.2	345	23.1
AR	12	0.8	214	15.8
AZ	-83	-3.4	337	16.5
CA	-420	-13.0	99	3.7
CO	-30	-1.2	422	19.9
CT	-31	-1.1	850	42.0
DE	261	9.6	665	28.8
FL	135	6.3	568	33.0
GA	98	4.6	544	32.3
HI	287	10.8	532	22.1
IA	252	11.8	485	25.5
ID	-26	-1.4	89	5.2
IL	81	3.6	307	15.3
IN	174	9.3	361	21.6
KS	113	5.0	446	23.0
KY	93	5.3	279	17.9
LA	205	10.5	339	18.8
MA	-582	-17.4	447	19.3
MD	-208	-7.1	443	19.3
ME	164	7.4	669	39.4
MI	103	4.1	370	16.5
MN	121	4.2	644	27.0
MO	45	2.5	380	25.4
MS	34	2.0	212	13.9
MT	99	4.4	359	18.1
NC	173	9.5	528	35.9
ND	-140	-5.7	251	12.3
NE	-39	-1.6	322	16.0
NH	-180	-8.1	523	34.5
NJ	-83	-2.8	760	35.0
NM	292	12.7	589	29.4
NV	-108	-4.2	126	5.4

TABLE 3.1 (Continued)

Difference in Actual Per Capita Own Source Revenues in 1988 Relative to (A) Growth in Personal Income or (B) Growth in Population and Inflation from 1978 to 1988.

State	Difference Relative to Growth in Personal Income		Difference Relative to Growth in Population and Inflation	
	[+/- \$1988]	[%]	[+/- \$1988]	[%]
NY	-8	-0.2	838	29.0
OH	279	14.8	486	29.0
OK	250	13.6	443	26.9
OR	122	5.2	346	16.3
PA	-22	-1.0	320	17.0
RI	98	4.1	547	28.3
SC	158	8.9	428	28.2
SD	-63	-3.1	245	14.2
TN	-10	-0.5	328	21.9
TX	236	12.2	489	29.1
UT	225	11.8	415	24.3
VA	2	0.1	519	29.7
VT	-24	-0.9	641	33.8
WA	-99	-3.8	286	13.1
WI	-98	-3.7	330	15.0
WV	156	9.7	214	13.8
WY	900	31.6	1,011	27.0
US Average [population weighted]	17	0.7	429	21.0

State-level TELs appear to have had little effect. Contrasting the real growth in per capita own source general revenues between 1978 and 1988 in states with and without state-level TELs, no significant differences can be found. As shown in Table 3.2, twenty states with state-level TELs experienced real growth that averaged \$288 per capita, while 28 states without such TELs had real growth in own source general revenues that averaged \$326 per capita.⁷ While the difference, \$38 per capita, is in the direction one would hypothesize--states with TELs experienced lower average growth than states without--the difference is not statistically significant.⁸

⁷ Alaska and Wyoming exhibited quite volatile taxing and spending patterns during this period, principally as a result of varying mineral revenues. They are excluded from the analysis for this reason.

⁸ The t-statistic for the difference is 0.97, statistically insignificant at the .10 level.

TABLE 3.2

Change in Own Source General Revenues from 1978 to 1988 in Real Dollars per Capita.^a

Restrictions on Local Governments	Restriction on State		Marginals
	No	Yes	
Very Restrictive	\$291.05 (102.09) 4	\$210.00 (95.91) 8	\$237.00 (101.44) 12
Fairly Restrictive	\$302.99 (146.3) 8	\$329.70 (151.17) 8	\$316.34 (144.38) 16
Not Restrictive or None	\$381.82 (140.56) 10	\$351.95 (51.11) 2	\$376.84 (128.60) 12
No Response	\$285.13 (123.24) 6	\$365.01 (177.95) 2	\$305.10 (129.38) 8
Marginals	\$325.61 (134.05) 28	\$287.57 (134.02) 20	\$309.76 (133.95) 48

^a Key: \$XXX.XX -- average increase for states in category,
not weighted by population.
 (XXX.XX) -- standard deviation of increase.
 X -- number of states in category.

Some limits on local governments, on the other hand, do appear to have constrained real growth in combined state/local own source general revenues. The National Conference of State Legislatures surveyed state and local officials to ascertain their perceptions of how restrictive state limits on local governments were in each state.⁹ Ratings were obtained from officials in 32 states using the scale "very restrictive" (12 states), "fairly restrictive" (16 states), and "not restrictive" (4 states). Eight states without restrictions, or with non-binding full-disclosure limits were added to the "not restrictive" category for this analysis. The real growth in per capita own source revenues between 1978 and 1988 in those states coded as "very restrictive" with respect to their local governments averaged \$237, in states coded as "fairly restrictive", \$316, and in states either having no restriction or coded as "not restrictive", \$377. The differences between states coded as "very restrictive" and "fairly restrictive", and between "very restrictive" and "not restrictive" states are both

⁹ Gold and Fabricius, *op cit.*, p. 21.

statistically significant at levels exceeding .05 and, for the latter comparison, .01.¹⁰ That is, there is less than a 5 percent chance that the differences between "very" and "fairly restrictive" states occurred by chance, and less than a 1 percent chance that the differences between "very" and "not restrictive" states did so.

Expenditure Effects

Turning to state/local expenditures, the evidence for government growth limitation is even weaker than for revenues. Most states increased their own source expenditures relative to personal income over the ten year period. In 1988, only 10 states had total state/local expenditures that were lower as a percent of personal income than they had been in 1978 (for state-by-state changes, see Table 3.3). Every state experienced real growth in own source state/local expenditures relative to population, with a ten-year increase nationwide of 27 percent by this measure. In addition to expenditure growth made possible by increased user charge and miscellaneous non-tax revenues during this period, state/local own source expenditures also grew by virtue of decreases in surplus and/or increased revenue from debt instruments,¹¹ thus accounting for the difference between aggregate revenue and expenditure effects.

TABLE 3.3

Difference in Actual Per Capita Expenditures from Own Sources in 1988 Relative to (A) Growth in Personal Income or (B) Growth in Population and Inflation from 1978 to 1988.

State	Difference Relative to Growth in Personal Income		Difference Relative to Growth in Population and Inflation	
	[+/- \$1988]	[%]	[+/- \$1988]	[%]
AK	5,025	62.7	2,975	59.0
AL	49	3.0	278	19.4
AR	183	13.7	356	30.6
AZ	336	14.5	731	38.1
CA	23	0.8	469	20.2
CO	148	6.4	557	29.0
CT	140	5.3	946	51.2
DE	561	25.0	897	46.9
FL	175	8.4	591	35.7
GA	287	15.5	673	46.1
HI	-229	-8.6	18	0.7
IA	85	4.0	317	16.7
ID	47	2.7	156	9.7
IL	55	2.6	272	14.2
IN	340	21.7	498	35.3

¹⁰ The difference between "fairly" and "not restrictive" states, however, is not significant by standard statistical test.

¹¹ In concert with the increase in state/local debt nationwide, real per capita interest payments on state/local debt grew by 80 percent from 1978 to 1988.

TABLE 3.3 (Continued)

Difference in Actual Per Capita Expenditures from Own Sources in 1988 Relative to (A) Growth in Personal Income or (B) Growth in Population and Inflation from 1978 to 1988.

State	Difference Relative to Growth in Personal Income		Difference Relative to Growth in Population and Inflation	
	[+/- \$1988]	[%]	[+/- \$1988]	[%]
KS	-33	-1.5	294	15.5
KY	172	10.6	344	23.8
LA	247	13.8	371	22.2
MA	-136	-4.7	746	37.6
MD	-304	-11.0	308	14.3
ME	113	5.7	567	37.1
MI	301	12.9	550	26.3
MN	208	7.7	692	31.4
MO	189	11.8	482	36.9
MS	200	13.3	359	26.5
MT	-57	-2.7	193	10.1
NC	120	6.8	464	32.6
ND	79	3.6	429	23.4
NE	38	1.8	361	20.1
NH	-105	-4.8	591	39.5
NJ	-17	-0.6	774	37.9
NM	549	30.3	783	49.6
NV	191	8.0	409	18.9
NY	110	3.2	882	33.4
OH	216	11.2	428	25.0
OK	321	20.3	487	34.4
OR	80	3.5	297	14.4
PA	9	0.4	326	18.6
RI	180	7.9	613	32.9
SC	257	15.9	501	36.6
SD	-192	-9.9	103	6.2
TN	-2	-0.1	325	22.5
TX	317	17.7	551	35.5
UT	200	11.0	381	23.4
VA	200	9.7	669	42.3
VT	107	4.9	679	41.7
WA	-114	-4.6	254	12.1
WI	119	5.1	504	25.6
WV	110	6.7	168	10.7
WY	1,121	50.7	1,207	36.2
US Average [population weighted]	128	5.7	507	27.0

Whether or not a state chose to adopt a state or local-level TEL between 1978 and 1988 had virtually no effect on aggregate expenditure growth. The data in Table 3.4 show that the 20 states with state-level TELs had average real growth of \$356 in per capita spending from own sources between 1978 and 1988, while the 28 states without state-level TELs had lower average real growth in own source spending--\$341 per capita. States with restrictions on local governments perceived by state and local officials to be "very restrictive" had average real per capita growth of \$340 by this measure. States perceived as "fairly restrictive" had average real growth of \$345 per capita, and those perceived as "not restrictive" or having no limits averaged \$386 per capita real growth. The differences among these three categories, while in a direction consistent with the differences in restriction stringency, are too small to be of statistical significance.

TABLE 3.4

Change in Own Source General Expenditure from 1978 to 1988 in Real Dollars per Capita.^a

Restrictions on Local Governments	Restriction on State		Marginals
	No	Yes	
Very Restrictive	\$350.38 (70.35) 4	\$334.31 (153.59) 8	\$339.67 (128.15) 12
Fairly Restrictive	\$295.74 (149.88) 8	\$395.14 (165.33) 8	\$345.44 (160.86) 16
Not Restrictive or None	\$426.32 (143.66) 10	\$183.20 (267.93) 2	\$385.80 (179.91) 12
No Response	\$253.02 (163.72) 6	\$454.61 (307.42) 2	\$303.42 (203.36) 8
Marginals	\$341.03 (152.49) 28	\$355.56 (180.34) 20	\$347.08 (162.97) 48

- ^a Key: \$XXX.XX -- average increase for states in category,
not weighted by population.
 (XXX.XX) -- standard deviation of increase.
 X -- number of states in category.

Wisconsin's Experience

Wisconsin did not adopt a TEL during the years of the tax revolt. Taxing and spending decisions in Wisconsin from 1978 through 1988 were made using the state's normal political processes rather than under the shadow of a mandated limitation. In 1986, the Wisconsin Expenditure Commission issued its report on Wisconsin's state and local spending, calling for a limitation on future growth aimed at returning spending per \$1,000 personal income in the state to nationwide average levels by 1992-93, and restricting spending growth to growth in state personal income after that goal was reached.¹² The limit recommended, based on projections of total United States and Wisconsin spending through 1992-93, was an allowable annual increase of between 3.8 and 4.6 percent in combined state and local spending during the six year period.

The Commission's 1986 recommendation for a formal limitation on spending in Wisconsin was not adopted. However, real spending in the state did decline relative to the national average in the following two years--1987 and 1988. The increase in total state/local spending per capita in Wisconsin between 1986 and 1987 was 4.6 percent, and 4.3 percent between 1987 and 1988, both within the range recommended by the Commission. State/local per capita spending from own sources (exclusive of federal funds) in Wisconsin increased by 5.2 percent between 1986 and 1987, and 5.8 percent from 1987 to 1988, however, as state and local governments substituted their own spending for declining federal funds.

Using the data in Tables 3.1 and 3.3 above to index fiscal restraint in each state, Wisconsin's experience relative to other states can be assessed. The measures of fiscal restraint are the dollar difference terms in the tables. The smaller the difference in absolute value for each data series, the more restrained in growth by that indicator a given state has been.

The data indicate a relatively high level of restraint in own source revenue growth in Wisconsin relative to the 50 states' experience from 1978 to 1988 (Table 3.1). Wisconsin's decline in own source revenue relative to personal income--from 1978's 18 percent to 1988's 17.3 percent--was the eighth largest decline of any state's. It resulted from a drop in revenues from the state's income taxes, offset somewhat by increased revenues from sales taxes and, especially, user charges and miscellaneous non-tax revenues. Wisconsin was the only state among its neighbors--Illinois, Iowa, Michigan, and Minnesota--to experience a decline in own source revenues relative to personal income from 1978 to 1988 (Figure 3.1). In fact, its neighbors all experienced growth in this index greater than the national average. Wisconsin's real increase in own source revenue relative to change in population was 15th among the 50 states--lower than all of its neighbors except Illinois.

Wisconsin exhibited somewhat less restraint in own source spending growth than in revenue during the period. Its increase in own source spending relative to income in the state, from 1978's 16.1 percent to 1988's 17 percent, ranked it 15th--14 states had lower and 35 states greater increases (Table 3.3).¹³ Wisconsin's growth in spending by this measure placed the state in the middle of its neighbors, with greater growth than that experienced in Illinois or Iowa, and lower growth than Michigan's or Minnesota's (Figure 3.2). The state's increase in real per capita own source spending relative to population change ranked it 30th in this measure of restraint, but the state's growth in this indicator--25.6 percent--remained slightly below national average growth of 27 percent.

¹² Wisconsin Expenditure Commission, *Final Report*, December 1986, p. 22.

¹³ Wisconsin's own source spending relative to personal income was low relative to adjacent years in 1978. Had the base year used here been 1977, Wisconsin would have exhibited a decline in this measure by 1988.

FIGURE 3.1

Own Source General Revenues Wisconsin and Neighboring States

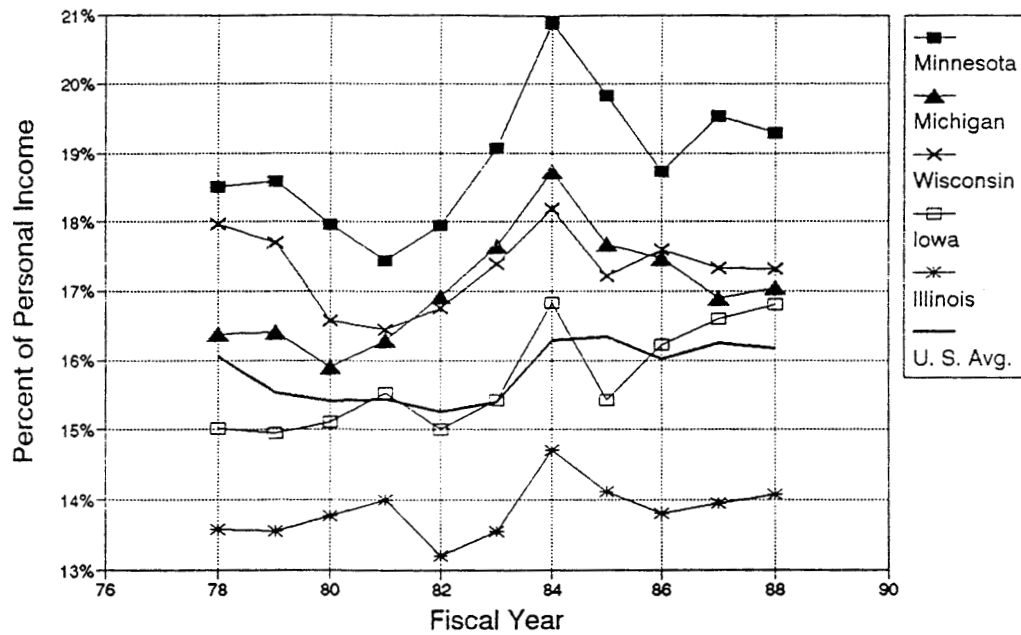
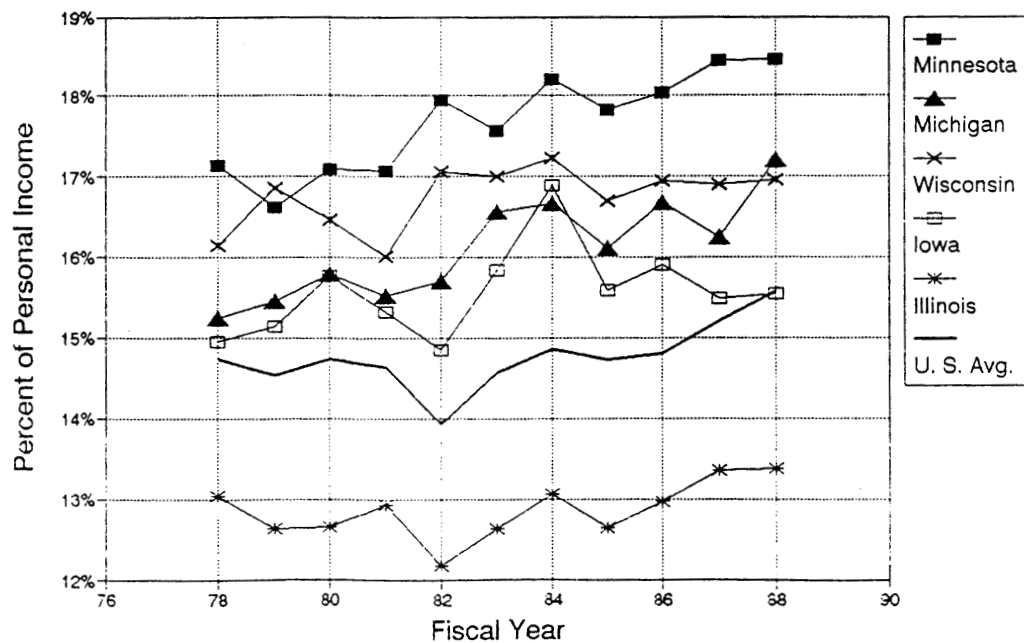


FIGURE 3.2

Own Source General Expenditures Wisconsin and Neighboring States



Summarizing the Wisconsin experience relative to other states--especially the most often-discussed TEL states whose experiences are the subject of the next chapter--the state's taxing and spending choices between 1978 and 1988 exhibited significant restraint. Wisconsin's own source revenues relative to income in the state actually declined, though not as much as in California or Massachusetts, while Missouri and New Jersey experienced increases. Real per capita revenue growth in Wisconsin lagged behind growth in Missouri, Massachusetts, and New Jersey, and exceeded California's. On the spending side, Wisconsin's growth in own source expenditures relative to personal income exceeded growth in Massachusetts, New Jersey, and California, and trailed behind Missouri's. In real per capita spending growth, Wisconsin had a somewhat larger increase than California or Missouri, but its increase was well below those of Massachusetts and New Jersey. Relative to all 50 states, Wisconsin exhibited above average fiscal restraint during this period--particularly in its growth in own source revenues, where its experience is difficult to distinguish from a number of other states that adopted fiscal limitations during the tax revolt years.

Conclusion

National comparative analyses of the effects of TELs on combined state and local revenues and expenditures lead to a general conclusion that TELs imposed little constraint on the growth of government. Certainly they did not halt growth, although some moderation in the rate of increase may have occurred in most states. But this moderation, to the extent that it characterized state and local finance over the last ten years, cannot be tied to TELs in the abstract. Aggregate comparisons of states with and without TELs reveal few significant differences between them.

This general finding is not enough to make TELs uninteresting, however. Aggregate comparisons alone are insufficient to assess effects of the variety of limitations imposed on particular state and local governments. To do the latter requires attention to the mechanisms employed by individual states, the incentives and constraints these mechanisms afforded state and local officials, and the impact these had on fiscal choices. We undertake such state-specific analysis in the following chapter.

LOCAL FISCAL LIMITATIONS IN SELECTED STATES

Lessons from Experience

Although one can clearly identify a period in the late 1970s and early 1980s during which a tax and expenditure limitation (TEL) movement swept through the states, each reform effort has a distinct story to tell. The circumstances and motivations surrounding local fiscal reform vary dramatically from state to state and, as a result, so do the institutional features of the fiscal arrangements created by reform acts. With different initial conditions and different institutional mechanisms created, it is hardly surprising that the fiscal effects of TELs are varied, making TELs difficult to study as a single body.

In this chapter we summarize the fiscal rules in four states selected as examples of the major institutional arrangements created in the TEL movement. Most summaries of TELs among the fifty states simply count the number of instances of particular types of rules. Thus we can learn from the Advisory Commission on Intergovernmental Relations (ACIR) and the National Conference of State Legislatures (NCSL) approximately how many states have rate limits, assessment limits, levy limits, expenditure limits, and so on.¹ Only seven states--Wisconsin included--seem to have no limit whatsoever. The states with limits can be compared to states without limits, as we did in the previous chapter, in order to examine the fiscal effects of tax and expenditure limitation *sui generis*. Finding little if any significant effect, we turn now to an examination of different combinations or configurations of fiscal rules in order to learn more about the possible effects of variation among TELs.

Tax reform legislation is inordinately complex. The effect of one type of rule often depends on what the other rules are. Tax reform is a problem of institutional design, in which rules can be combined in various ways with a view to avoiding some possible outcomes while making others more likely. The configuration of rules amounts to a fiscal constitution that shapes patterns of interaction among diverse decision makers at different levels of government--voters, elected officials, and service producers. Tax and expenditure rules are not policies that can be fine-tuned to get particular results but fiscal constitutions that establish the terms and conditions under which political transactions can occur. Constitutional rules can establish boundaries around those transactions, but cannot determine the precise results.

Historically, local fiscal constitutions were rather simple. Property tax rate limits imposed by state constitutions or statutes on local governments, sometimes accompanied by procedures for override by local voters, provided the principal method of fiscal limitation. In a context where property reassessment was infrequent and existing assessments were well below market value, rate limits were an effective instrument for controlling the size of property tax levies. Because local governments traditionally were limited to the property tax as their major revenue source, property tax rate limits also constrained local revenues and expenditures more generally. The constraining effect of rate limits on local expenditures tended, however, to erode over time, as state legislatures added exceptions and authorized new sources of revenue.

The obsolescence of property tax rate limits as the sole device for controlling local taxing and spending finally became clear in the 1970s, when improvements in tax assessment practices along with escalating property values and rapid inflation pushed property tax revenues up and up in many states without any increase--or even with decreases--in rates. Assessment limits, levy limits, and expenditure limits became the new favored mode of restriction, even as most rate limits remained in effect. Wisconsin, too, flirted briefly with local levy limits in the 1970s. The effectiveness of the new limits, however, remains very much in doubt, as evidenced in our analysis in the preceding chapter.

¹ Advisory Commission on Intergovernmental Relations, *Significant Features of Fiscal Federalism*, published annually; Steven D. Gold and Martha A. Fabricius, *How States Limit City and County Property Taxes and Spending*, Washington, D.C.: National Conference of State Legislatures, March 1989.

Four States

We consider four states in detail: California, Massachusetts, Missouri, and New Jersey. Of the four, the case most typical of the TEL movement is New Jersey, which created an expenditure limit for municipalities. Missouri relies on a rollback of tax rates following reassessment combined with voter approval of tax rate increases. Only Michigan and Ohio use substantially the same rule configuration as Missouri. California and Massachusetts, together with Idaho, were the only states to compel an actual reduction in local property tax revenues. Yet they drew on quite different rule configurations to bring about that result, with different future implications.

California

California's new fiscal constitution was shaped primarily by Proposition 13, adopted by voters in a statewide referendum in 1978, and, secondarily, by Proposition 4, adopted the following year. Other features were provided by legislative statute, some prior to 1978-79, some subsequent. A major circumstance leading to the adoption of Proposition 13 was a rapid escalation in assessments caused by increasing property values amidst sharp general inflation.²

Proposition 13, which focused on property tax reform, established limits that apply both to the allowable tax base and the tax rate. State law already required property valuation at 100 percent of market value. Proposition 13 limited reassessments of individual parcels to an annual increase of no more than 2 percent, except when a parcel is sold, at which time it is reassessed at market value. The individual parcel limitation, in turn, curtails growth of the property tax base, sharply limiting the elasticity of the property tax. At the same time, Proposition 13 limited property tax rates to no more than 1 percent of assessed value, without provision for override. The combined effect of limiting growth in the property tax base and cutting property tax rates was to compel a decrease in local reliance on property tax revenues. Henceforth, the only way that local communities could influence their property tax revenues was by encouraging or discouraging development.

Limits adopted on non-property tax sources were not as severe, but still stringent. Local jurisdictions were allowed to adopt new taxes, as permitted by state law, but only by a two-thirds majority vote in a referendum. At the time of adoption of Proposition 13 only home-rule cities were allowed a wide range of revenue choices, but in 1983, the state legislature extended the same capability to all cities.³ Counties, school districts, and other special districts, however, are still limited primarily to the property tax.

Proposition 4 added to the property tax restrictions a limitation on expenditure growth from all tax sources. The rate of increase in tax-source appropriations was to be no more than the rate of population growth plus the inflation rate (or plus the rate of growth in per capita income if less than inflation). The limit applied to both state and local governments. Overrides are allowed by majority vote in a referendum.

User charges were defined under Proposition 4 as a non-tax source of revenue as long as the amount of the charge was no more than required to cover costs. User charges in excess of costs were to be considered taxes, and would be subject to the expenditure limit. However, as long as the local jurisdiction remained within its expenditure limit, it could apply revenues from user charges to any expense.

² See Jack Citrin and Frank Levy, "From 13 to 4 and Beyond: The Political Meaning of the Ongoing Tax Revolt in California," in George G. Kaufman and Kenneth T. Rosen, *The Property Tax Revolt: The Case of Proposition 13*, Cambridge, MA: Ballinger Publishing Co., 1981, pp. 3-8.

³ Gary J. Reid, "How Cities in California Have Responded to Fiscal Pressures Since Proposition 13," *Public Budgeting & Finance* 8 (Spring 1988), p. 20.

TABLE 4.1

CALIFORNIA'S LOCAL TAX/EXPENDITURE LIMITS

<u>Assessments:</u>	Individual-parcel limits, maximum 2 percent annual increase.
	<u>Exceptions:</u> New construction, newly purchased property.
<u>Rates:</u>	Maximum 1 percent applied to combined levy from all taxing jurisdictions in each locality.
	<u>Overrides:</u> None.
	<u>Exceptions:</u> Debt service on general obligation bonds.
<u>Levies:</u>	No restriction.
<u>Expenditures:</u>	Rate of annual increase not to exceed growth in population plus growth in consumer price index or personal income, whichever is less.
	<u>Overrides:</u> A simple majority of voters may override the expenditure limit for any one year.
	<u>Exceptions:</u> Expenditures financed from user charges that are applied exclusively to support the particular service.
<u>Other Rev:</u>	New revenues from non-property tax sources may be adopted only with approval from a two-thirds majority of voters in municipalities. Counties, school districts, and special districts are limited mainly to the property tax.

Proposition 13 presented a serious difficulty in allocating property tax revenues collected under the 1 percent maximum rate among local governments.⁴ The method of allocation was not specified by the ballot initiative and, therefore, remained to be resolved by the state legislature. The legislature decided on historical tax collections modified by growth in assessed valuations as the criterion for allocating local property tax revenues. Local governments with historically high tax levies continued to receive larger proportions of the total property tax levy, as modified each year by relative growth in assessed valuations. Some local governments received no property tax allocation under this rule.

The immediate effect of Proposition 13 was to reduce property tax revenues by an estimated \$7 billion in one year's time, declining from a level more than 50 percent above the national average to 35 percent below the national average. A large state surplus, however, initially enabled the state legislature to shelter local governments from the steep decline in local tax revenues. Subsequently, the state shifted the property tax base away from school districts in favor of cities and counties.⁵ State support of schools increased dramatically. State aid to counties also increased, but state aid to cities and special districts declined. Cities turned increasingly to user charges and fees as the main source of revenue growth, as did special districts.

⁴ Rodney T. Smith, "Local Fiscal Arrangements After Proposition 13", Lowe Institute of Political Economy, Claremont McKenna College, 1988.

⁵ *Ibid.*, pp. 22-33.

Real per capita revenues for counties and school districts remained below pre-Proposition 13 levels in 1988, but cities and special districts had sufficient revenue growth to push them above those levels.⁶

Both city and county governments also changed the composition of their budgets after Proposition 13. By far, the deepest cuts were made in spending for general government and administration. The spending share allocated to health and public aid by counties also decreased somewhat, while the shares allocated to public safety by both cities and counties increased.⁷ The pattern can be interpreted as a shift away from expenditures for indirect services not easily observable to the public (such as general government and public works maintenance) and away from non-essential services (such as parks and recreation, and libraries⁸), toward expenditures that are highly visible and essential (police and fire protection, health services in the case of cities).⁹

Massachusetts

Unlike California, tax reform in Massachusetts was spurred by high tax rates rather than by rapidly increasing assessed valuations.¹⁰ Just prior to Proposition 2 1/2, municipal property taxes averaged \$555 per capita compared to a national average of \$290.¹¹ Few alternative tax revenue sources were available to local governments.

Like Proposition 13 in California, Proposition 2 1/2, passed by Massachusetts voters in November, 1980, focused on the property tax.¹² Both placed a limit on the rate, but Massachusetts limited the tax levy rather than assessments. While California limited the combined rate for all jurisdictions within a given locality, Massachusetts applied its rate and levy limits to municipalities, which also appropriate funds for school districts. Counties and special districts make assessments to municipalities; these assessments were limited by the tax reform, first to a 4 percent and then to a 2.5 percent increase annually. Also like California, Massachusetts moved to 100 percent valuation of property.

⁶ *Ibid.*, pp. 34-35.

⁷ *Ibid.*, p. 37.

⁸ Hansen reports that public library spending fell for third place to forty-third place among the fifty states in three years. Susan B. Hansen, *The Politics of Taxation: Revenue without Representation*, Praeger, 1983, p. 219.

⁹ Reid, *op.cit.*, p. 26.

¹⁰ Sherry Tvedt Davis, "A Brief History of Proposition 2 1/2," in Lawrence E. Susskind and Jane Fountain Serio (eds.), *Proposition 2 1/2, Its Impact on Massachusetts*, Cambridge, MA: Oelgeschlager, Gunn & Hain, 1983, pp. 4-5.

¹¹ Katharine L. Bradbury and Helen F. Ladd, with Claire Christopherson, "The Initial Impact on State and Local Finances," in Susskind and Serio, *op. cit.*, p. 294.

¹² See Alan Tosti, "Proposition 2 1/2 Amended: What Communities Can and Cannot Do," in Susskind and Serio, *op. cit.*, pp. 11-15.

TABLE 4.2

MASSACHUSETTS' LOCAL TAX/EXPENDITURE LIMITS

<u>Assessments:</u>	No restriction.
<u>Rates:</u>	Maximum 2.5 percent applied to municipalities.
<u>Overrides:</u>	None.
<u>Levies:</u>	Rate of increase for municipalities limited to 2.5 percent.
<u>Exceptions:</u>	New construction.
<u>Overrides:</u>	A simple majority of voters may raise the levy up to 5 percent. A two-thirds majority may raise it more than five percent.
<u>Other Rev:</u>	Municipalities have few other sources of tax revenue.

The rate limit in Massachusetts is 2.5 percent of assessed value. The levy limit is a 2.5 percent increase in the property tax levy per year. Growth in property tax revenue, under these rules, can result only from growth in assessed valuation. Aggregate revenue growth is limited to 2.5 percent per year, unless there is new construction being taxed for the first time. Property tax revenue from new construction is exempt from the levy limit (a feature added by amendment).

Overrides of the rate limit are not permitted. Thus communities can no longer adjust property tax revenues by adjusting the rate (unless adjusting downward). Overrides of the levy limit are permitted by referendum. A two-thirds vote of selectmen or council members is required to place an override question on the ballot at a general or special election. A simple majority of voters may raise the levy up to 5 percent. A two-thirds majority may raise it more than five percent. The size of the total levy, however, continues to be constrained by the rate limit.

The property tax rules can be summed up as follows: The base is allowed to grow, but the rate is capped. If growth in the base allows for potential revenue growth, the levy can increase by up to 2.5 percent without voter consent. With voter consent it can increase by up to 5.0 percent and, with two-thirds approval, even more. But all of this revenue growth must derive from growth in the tax base, not an increase in the tax rate.

A major difference between Massachusetts and California is that Massachusetts put a premium on up-to-date and accurate assessments as a means of increasing potential revenues. Unlike California, increases in assessments on individual parcels were not limited. The ability to draw on an expanding tax base, however, is more likely to require recourse to the voters in Massachusetts than in California. Massachusetts's 2.5 percent levy limit is much more stringent than California's (Proposition 4) expenditure limits, which are tied to population and either inflation or per capita income growth. Although California limits growth in the property tax base by limiting individual assessment increases to 2 percent per year, growth from new construction and reassessment due to sale of property is allowed. When California's property tax base grows, its levy can grow proportionately as long as the expenditure limit is not reached.

Although some service cutbacks were necessitated in many municipalities across Massachusetts, the immediate impact of Proposition 2 1/2 was not as severe as anticipated.¹³ Municipalities that had not been valuing property at 100 percent of market value were able to garner additional revenues from revaluation, cushioning the impact of rate reduction. The legislature voted additional state aid that, because it was distributed according to a previous formula, differentially affected local municipalities--some more than making up their loss of tax revenues, others receiving less than 25 percent of their tax loss. Many municipalities also introduced and/or increased user charges in areas such as water and sewer services and parks and recreation.¹⁴ By 1988, 202 out of 351 cities had voted on overrides, with an approval rate of 72.8 percent.¹⁵

New Jersey

In 1976, the New Jersey legislature subjected counties to a property tax levy limit and municipalities to an expenditure limit.¹⁶ The more general limit was used in the case of municipalities because they draw on a larger number of revenue sources, while counties are financed mainly from the property tax. Here we concentrate on the municipal limit.

The issue of local government tax and expenditure limitation arose in New Jersey as a side-issue to education finance reform. The state supreme court had held the New Jersey school system in violation of the state constitution, requiring the legislature to replace the local method of financing schools from property taxes. In order to equalize funding across school districts, the legislature strictly limited school spending from local sources, thus reducing school district property tax levies across the state. To ensure that the reduction in school district levies would be applied to property tax relief, the legislature also decided to impose limits on counties and municipalities.

The expenditure limit (technically an appropriations limit) restricts growth in the municipal budget to no more than 5 percent per year, with the following exceptions: (1) An amount equal to revenue raised by applying the previous year's tax rate to the assessed value of new construction and improvements; (2) capital expenditures not funded by the local property tax; (3) programs that are financed wholly or in part from federal or state funds and that do not require a municipal share greater than 5 percent of final appropriations; (4) all debt service, amounts required for funding a preceding year's deficit; (5) expenditures mandated after the effective date of the act by state or federal law; and (6) expenditures of amounts derived from new or increased service fees or from the sale of municipal assets. In other words, the expenditure limit is 5 percent plus revenue from new construction, expenditures for capital improvements, federal and state-aided programs, new state and federal mandates, debt service, and increases in user charges. Exempt from the limit are all municipalities with a property tax rate of less than 1/10 of 1 percent. The 5 percent limit can be overridden in either of two ways. One is for two-thirds of the local governing body to declare an emergency, allowing extra spending up to 3 percent of the current utility operating appropriation. The other is to obtain majority approval in a popular referendum.

¹³ Lawrence Susskind and Cynthia Horan, "Understanding How and Why the Most Drastic Cuts Were Avoided," in Susskind and Serio, *op. cit.*, pp. 263-270.

¹⁴ Patricia L. McCarney, "Increasing Reliance on User Fees and Charges," in Susskind and Serio, *op. cit.*, pp. 351-355.

¹⁵ Gold and Fabricius, *op. cit.*, p. 23.

¹⁶ The following summary is based on an account by David Merriman, *The Control of Municipal Budgets: Toward the Effective Design of Tax and Expenditure Limitations*, New York: Quorum Books, 1987, pp. 83-119.

TABLE 4.3

NEW JERSEY'S LOCAL TAX/EXPENDITURE LIMITS

<u>Assessments:</u>	No restriction.
<u>Rates:</u>	No restriction.
<u>Levies:</u>	Maximum 5 percent increase (applied to counties only).
<u>Expenditures:</u>	Maximum 5 percent increase annually (applied only to municipalities with a property tax rate of 0.1 percent or greater).
<u>Exceptions:</u>	(1) Revenue from new construction and improvements; (2) capital expenditures not funded by the local property tax; (3) federal and state aided programs that do not require a municipal share greater than 5 percent of appropriations; (4) all debt service; (5) expenditures mandated after the effective date of the act by state or federal law; and (6) expenditures of amounts derived from new or increased service fees or from the sale of municipal assets.
<u>Overrides:</u>	(1) Two-thirds of the local governing body may declare an emergency, allowing extra spending up to 3 percent of the current utility operating appropriation; or (2) Approval by a majority voters.

David Merriman has conducted a careful study of the effects of the municipal expenditure limit, attempting to compare actual spending with predicted spending in the absence of the limitation. He is unable to conclude that the limitation had any significant effect, either on exempt or non-exempt expenditures.¹⁷ Two additional findings, however, are important. First, voter override activity was relatively light, but not inconsequential.¹⁸ Between 1977 and 1984, 292 referenda were held, with an approval rate of 43 percent. The average number of referenda per year (about 36) is relatively small compared to the number of municipalities (more than 400) subject to the limit over the period. Perhaps more telling, a 1981 survey indicated that 83.7 percent of all municipal officials would not consider seeking a voter override in the future. Second, the "vast majority" of municipalities spent the maximum amount allowed.¹⁹ This occurred even when predicted spending, according to Merriman's model, was lower than the amount allowed by the 5 percent cap. As a result, many municipalities spent less than predicted by the model, but some spent

¹⁷ *Ibid.*, pp. 112-114.

¹⁸ *Ibid.*, pp. 90-91.

¹⁹ *Ibid.*, p. 155.

more.²⁰ The implication is that the expenditure limit actually increased spending in a significant number of municipalities. Merriman's explanation for this phenomenon is that municipal officials sought to maximize their spending base for the following year by spending the maximum amount allowed in the current year.²¹ One might interpret the strategy as a hedge against an uncertain future. Not knowing what future exigencies might bring, municipal officials maximized their future flexibility by spending the maximum allowed in the current year.²²

Missouri

In 1980, Missouri adopted a constitutional amendment, known as the Hancock Amendment, based on a citizen initiative to restrict both state and local spending, using an approach modeled after an amendment adopted in Michigan in 1978.²³ Ohio also has a similar arrangement. Unlike the other states considered here, Missouri is a low-tax state. Between 1972 and 1980, total real spending for state and local governments in Missouri (1982 dollars) ranged from just under \$1,400 per capita to just under \$1,500 per capita. Massachusetts and California during this period were spending in the vicinity of \$2,100 per capita.

The limit placed on local governments in Missouri has two main elements: (1) a rollback provision that automatically adjusts property tax rates downward following any reassessment that would increase the property tax levy more than inflation (measured by the consumer price index); and (2) a requirement of approval by a majority of voters in order to increase rates. In effect, the current rate (after a rollback) becomes the rate limit for local officials. These limits were imposed in addition to a variety of constitutional and statutory rate limits that continue to operate, some of which require a two-thirds majority to override.²⁴ Other revenue sources are also available to local governments in Missouri, especially sales taxes and utility taxes, but any tax increase under the new limitation requires voter approval. One of the interesting features of the Missouri amendment was the inclusion of user charges in the voter approval requirement.

²⁰ Sixty-one percent of the municipalities in Merriman's sample spent less than the predicted amount on non-exempt goods. The average effect of the expenditure limit was to reduce spending by an estimated \$3.91 per capita. *Ibid.*, p. 112.

²¹ *Ibid.*, pp. 89, 113, and 153. In 1983, following the period of his study, Merriman reports that New Jersey's law was modified to allow municipalities to "carry forward" unused spending authority for a two-year period.

²² Merriman also notes an increase in both the rate of formation of special districts by New Jersey municipalities and in special-district revenues during the first years of the expenditure limit. Initially, the spending limit could be avoided by shifting responsibility to a special district, but, since 1980, allowable spending has been reduced following a reduction in municipal responsibility. *Ibid.*, p. 90.

²³ See Rhonda C. Thomas, "Recent Developments in Missouri: Local Government Taxation," *UMKC Law Review* 49 (1981), pp. 491-533.

²⁴ For a summary and discussion of Missouri's fiscal rules with respect to local governments, with special attention to St. Louis County, see Advisory Commission on Intergovernmental Relations, *Metropolitan Organization: The St. Louis Case*, M-158, Washington, D.C.: ACIR, September 1988, pp. 39-45.

TABLE 4.4

MISSOURI'S LOCAL TAX/EXPENDITURE LIMITS

<u>Assessments:</u>	Rollback of tax rate required after increase in assessed valuation.
<u>Exceptions:</u>	Increase in assessed valuation must equal increase in consumer price index before rollback occurs.
<u>Rates:</u>	Current rate (after rollback) is effective limit. Other constitutional and statutory limits apply to various classes of local jurisdictions.
<u>Overrides:</u>	Simple majority of voters may increase the current rate (after rollback).
<u>Levies:</u>	No restriction.
<u>Expenditures:</u>	No restriction.
<u>Other Rev:</u>	Adoption of sales tax requires voter approval. Increase in rate applied to any revenue source requires voter approval. Most revenue sources have statutory rate limits.

Two years after adoption, over 200 override questions had been presented to voters, including more than 150 fee increases. The approval rate for fee increases was 90 percent.²⁵ Some cities were able to increase fees markedly, while others experienced little growth.²⁶ The provision related to fees was later relaxed to exclude fee increases that are necessary to maintain the existing level of service.²⁷ Real per capita state and local spending in Missouri increased over the 1980s from roughly \$1,400 per capita to more than \$1,600 per capita. However, total general expenditure in the state declined as a percentage of personal income from nearly 16 percent to a little more than 14 percent immediately following the amendment, and had not risen by 1988 to as much as 15 percent, except in 1987.

²⁵ Rhonda C. Thomas, "The Hancock Amendment: The Limits Imposed on Local Governments," *UMKC Law Review* 52 (1983), pp. 22-44.

²⁶ Elaine B. Sharp and Dennis Elkins, "The Impact of Fiscal Limitation: A Tale of Seven Cities," *Public Administration Review* 47 (September-October 1987), pp. 385-392.

²⁷ Gold and Fabricius, *op. cit.*, p. 27.

Lessons From Experience

The four states examined above provide an overview of the major institutional mechanisms used to limit local taxes and spending. Although no two states are completely alike (i.e., there are as many different rule configurations as there are states), these four cases allow us to identify the principal combinations of rules and their likely consequences. We cannot draw definitive conclusions on every point of interest, but there are some important lessons to be learned from the range of state-local experience.

We divide the TEL experience of the states into four main groups:

- (1) States that severely limited the property tax as a local revenue source and, in effect, removed it from local discretion (California, Massachusetts, Idaho);
- (2) States that relied primarily on a property tax levy limit, general revenue limit, or expenditure limit, and that defined the allowable increment of growth as a fixed percentage (12 or more states);²⁸
- (3) One state (Nevada) that relied primarily on a levy, revenue, or expenditure limit and tied the allowable increment in local revenues or expenditures to growth in population or personal income and/or to inflation (a number of states rely on this type of limit to constrain state-level taxing or spending);
- (4) States that combined property tax rollbacks (following reassessment) with rate limits that require voter overrides to raise rates (Michigan, Missouri, Ohio).

The more famous "tax revolt" states are those that effectively removed the property tax from local control. They are a distinct minority among all states limiting local taxes and spending. By far the most common approach to fiscal limitation is a fixed percentage limit in revenue or expenditure growth, represented in the four cases examined above by New Jersey. Tying the allowable increment in revenues or expenditures to some variable index, such as inflation, is much less common. It is found in the case of California's expenditure limit (Proposition 4), but was not the main source of local tax and expenditure limitation in that state.

Removing the Property Tax from Local Control

In both California and Massachusetts, the property tax was so severely restricted as a local revenue source that it was effectively removed from local discretion. One analyst writing on California explicitly treats the property tax as an "exogenous" revenue source--beyond local control.²⁹ This is particularly true in California where the 1 percent limit on property tax rates was applied, not to individual jurisdictions, but to the total levy of all jurisdictions in a locality. In Massachusetts, municipalities retain somewhat greater control, but are still limited by a low 2.5 percent rate and a 2.5 percent levy increment. Both states so severely restrict local communities from using their discretion to raise additional revenues from the property tax that it no longer can be used as a fiscal instrument to aggregate local demand for local goods and services.

²⁸ Arizona, Colorado, Idaho, Indiana, Minnesota, Mississippi, New Jersey, New Mexico, North Dakota, Oregon, Rhode Island, and Washington. Massachusetts and Nevada also make use of fixed percentage limits among other constraints. Based on information from Gold and Fabricius, *op. cit.*, pp. 13-15.

²⁹ Reid, *op. cit.*

If the purpose is solely one of "property tax relief," and no other purposes are considered, the approach works. Additional benefits may be derived from efficiency gains in local governments, at least in the short term. In both California and Massachusetts, local officials scrambled to find ways of reducing costs without reducing services.³⁰ Given the lack of a profit motive to encourage government officials to seek out efficiencies, the added pressure provided by suddenly withdrawing a revenue source seems to have significant efficiency-enhancing effects. Some cost-cutting measures may be detrimental to efficiency in the long-term (e.g., deferring maintenance activities related to public works). Neither can we assume that reductions in administrative expense, such as observed in California, are confined to the elimination of waste and red-tape. Nonetheless, citizens are likely to be well-served by innovations and productivity improvements that maintain or improve service levels.

The most prominent, and perhaps the most lasting, effect of removing the property tax from local control, however, was a shift to other sources of revenue. In California, the predominant shifts were either to state aids or to user charges, depending on the type of local unit. Similar shifts occurred in Massachusetts. No more than a temporary disruption in local revenue growth appears to follow from even the most draconian reduction in property tax revenues.

A shift to user charges can, in most cases, be considered efficiency-enhancing. Under the rules of Proposition 4 in California, receipts from user charges are defined as non-tax revenue not subject to expenditure limits as long as those receipts are not used to support other services. User charges that cover the cost of service convey information to citizens about service costs, reducing fiscal illusion. User charges also limit demand as long as citizens are free to determine their rate of use. Although many local public goods and services are inappropriate for user-charge finance, those services that can be easily metered to individuals (e.g., garbage collection or water supply) and that do not have important income-transfer features can benefit from a shift to user-charge financing.

A shift to state aids is more problematic. Part of the basic rationale for autonomous local units of government is to create arrangements whereby local citizens can provide themselves with goods and services based on their preferences. These preferences include making a trade-off between public goods and private goods. State aids are monies collected on the basis of statewide trade-offs between public and private spending. If localities are highly constrained in their ability to raise additional revenues at the margin, a dependence on state aids is equivalent to an abandonment of local discretion and local responsibility for infrastructure and service improvements. The shift to state-level decision making can also affect the composition of local budgets, if aid is targeted to budget categories such as personnel or facilities or to some services in preference to others. Moreover, local taxpayers lose much of their incentive to monitor the fiscal performance of local service producers, resulting in a loss of public accountability.

Percentage-based Revenue or Expenditure Limits

We move from the most famous instances of tax and expenditure limitation to the most common. New Jersey, in our state-by-state discussion above, represents a large group of some 20 states that employ as their principal limit a rule that establishes a maximum increment in either revenues or expenditures based on a fixed percentage of the base. The most important implication of this rule is that it makes future taxing or spending authority strictly dependent on previous taxing or spending levels. In New Jersey, a 5 percent spending limit means that the maximum level of municipal expenditures in year $Y + 1$ depends on the level of spending in year Y . From his analysis of the New Jersey experience, Merriman concludes that "when allowed future spending (or taxing) depends upon past levels of spending (or taxing), decisionmakers have

³⁰ See John J. Kirlin, *The Political Economy of Fiscal Limits*, Lexington, MA: D.C. Heath, 1982, pp. 87-93; and John M. Greiner and Harry P. Hatry, "Coping with Cutbacks: Responses in 17 Local Governments," in Susskind and Serio, *op. cit.*, pp. 373-475.

an incentive to spend (or tax) the maximum amount allowed."³¹ This incentive derives from uncertainty about future exigencies. Local officials hedge against future revenue shortfalls by keeping their allowable spending authority at the maximum amount. At the same time, it is virtually impossible that a fixed-percentage limit will affect all localities in the same degree. New Jersey's 5 percent limit was constraining for some municipalities but not for others, using predicted expenditures in the absence of the limit as a base for comparison. Some municipalities spend more than they would without the limit, while others spend less. The outcome is more a systematic distortion of local spending than it is a correction for systematic bias. Taxpayers in communities spending more as a result of the limit would surely regard the outcome as counterintentional.

The effect of percentage-based revenue and expenditure limits depends, of course, on the size of the taxing or spending increment allowed. The allowable increments range from a 2 percent limit on property tax levies in Arizona to a 10 percent limit in Mississippi. Most states are in the 5-8 percent range. Only four states are under 5 percent--one is Massachusetts, in addition to Arizona, plus Minnesota and North Dakota.³² A 5 or 6 percent increment is likely to be in a range where some communities will find themselves wanting to spend more, others less. A higher increment, such as Mississippi's 10 percent, would likely avoid this difficulty, but only by setting the allowable rate of increase so high that it constrains no one. A limit that does not limit will not cause local officials to hedge the future by spending the maximum amount in the current year. The result, again, is no effect. A lower increment, set so that virtually every community finds itself wanting to spend more, will also fail to constrain--except perhaps in the very short run. Without an override mechanism, such a limit is politically infeasible and will not be sustained. Arizona provides an example. With an expenditure limit of 2 percent, more than 40 out of 83 Arizona cities have received voter approval to exceed the limit.³³ While we might expect voter overrides to alter the politics of taxing and spending, the aggregate effect of this mechanism will depend substantially on the initial condition (how far away from citizen demand taxing and spending was at the time of adoption) and on exogenous factors that affect growth in citizen demand.

Revenue or Expenditure Limits Tied to a Variable Index

A few states utilize revenue or expenditure limits tied to a variable index, such as the consumer price index, personal income, or simply population. California's expenditure limit is tied, in this fashion, to population growth plus growth in either the consumer price index or personal income in the state, whichever is less. Arizona also has an expenditure limit tied to population and inflation, but indexed to the gross national product implicit price deflator. As in California, however, Arizona's spending lid is not the primary source of limitation on local taxing and spending. Only Nevada relies primarily on a limit tied to a variable index. Nevada's revenue limit, which is applied to the sum of local revenue from property and sales taxes, is tied to the consumer price index.³⁴ Fees are allowed to increase by only 80 percent of the index. At the same time, however, property tax revenues alone are limited to a 6 percent annual increase. The effect of the broader revenue limit depends on how the inflation rate compares to 6 percent and on sales tax revenues.

Tying a revenue or expenditure limit to a variable index potentially reduces incentives to spend the maximum amount allowed. Allowable taxing or spending in one year is no longer totally dependent on

³¹ Merriman, *op. cit.*, p. 155.

³² Two states (Kentucky and Texas) use a percentage increment with a property tax rollback. They are not included in this discussion.

³³ Gold and Fabricius, *op. cit.*, p. 23.

³⁴ Gold and Fabricius, *op. cit.*, p. 15.

actual taxing or spending in the previous year. The percentage size of the allowable increment will instead depend on exogenous factors, although the base will still depend on last year's level of taxing or spending. Incentives to spend the maximum amount as a hedge against the future would seem to be reduced if the allowable increment is indexed to population growth or, especially, to inflation. A personal income index might have less effect, insofar as growth in personal income can lag behind inflation. Each year's spending, however, still defines next year's base. A larger base means greater spending authority, whatever the percentage increment happens to be. In addition to population growth and inflation, local governments might wish to create a hedge against a possible loss of tax base, such as can be caused by plant closings or economic recession. Depending on what they expect the future to bring, some local governments might choose to spend more simply in order to increase their annual base. We might reasonably hypothesize that indexing a revenue or expenditure limit to something like the consumer price index would reduce, but not eliminate, the effect observed in New Jersey. Some jurisdictions, conceivably, would choose to tax or spend more as a result of the limit.

Rollbacks Plus Voter Overrides of Rate Limits

To constrain local taxing and spending, Michigan, Missouri, and Ohio rely principally on a combination of property tax rate rollbacks following reassessment plus a requirement of voter approval to raise any tax rate (not only property tax rates, but all tax rates). Property taxes remain a local revenue source subject to substantial local discretion. A rollback rule prevents reassessments from being easily translated into increased revenues, while exceptions and indexing allow for some revenue growth. The current tax rate is treated as a limit on local officials, subject to voter overrides. The effect of the rollback rule is to make property tax rates the principal instrument for controlling revenue increases. A local choice to increase property tax revenues (beyond those increases allowed from growth in the base) must be based on an explicit decision to raise the tax rate. Local officials may propose such an increase, but the decision lies with a majority of voters. Local discretion, if defined as the discretion of the community rather than that of the local government per se, is not curtailed in this approach. What is curtailed is the discretion of local officials vis-a-vis local citizens.

The rollback rule can be viewed as a different response to much the same situation that faced Californians in the mid-1970s: escalating property values that were viewed as producing tax windfalls for local governments. Some growth in assessed valuation is still permitted. Michigan and Missouri (but not Ohio) tie the allowable growth in assessed valuation to inflation. All three exclude new construction and improvements from the scope of the rollback requirement. Even if a fixed percentage were used to define an allowable increment in the growth of assessed valuation (as in California), an assessment limit would not create the same problem as a revenue or expenditure limit defined in these terms. One can assume that assessments will grow to the maximum allowable level and still rely on tax rates as a discretionary instrument for controlling revenues. The rollback rule is simply a means of constraining growth in the nominal property tax base so that property tax rates can and must be used to make decisions about revenues. Rollbacks focus attention on rates as the means of collective choice about property taxes.

These states do not, however, focus restriction exclusively on the property tax. All local taxes (and to some extent fees) are limited to the current rate unless voters approve an increase. Although the elasticity of local taxes varies, most local taxes are subject to potential growth in the tax base. Sales tax revenues, for example, are enlarged by increases in the nominal value of commercial exchange, and income tax revenues grow with increases in nominal personal income. Both are sensitive to inflation. Local-option sales and income taxes, however, are usually subject to statutory rate limits that virtually define the local rate and that cannot be increased at local discretion, not even by voters. This not only constrains the share of local revenues that can be provided from such sources, but also, once the local option is invoked, focuses attention on property tax rates as the principal means of increasing local revenues.

The rollback rule is accompanied by the required use of citizen referenda to raise rates. The fiscal constitution thus does more than focus everyone's attention on rates; it also vests the final decision on rate increases in voters rather than in elected officials. Numerous commentators have attacked such a provision as an affront to representative institutions. Is there a logic that would support the use of citizen referenda on this sort of question? To consider this issue, it is useful to examine again the relation between assessed valuation and rates.

Mathematically, the relation between assessed valuation and property tax rates is straightforward: The property tax levy equals assessed valuation multiplied by the rate of taxation. Increasing assessed valuation does not necessarily translate into an increasing tax levy. The effect of assessed valuation on the levy depends on the tax rate. Control over the tax levy is still in the hands of those who set rates. The political or institutional relation between assessed valuation and rates, however, is less straightforward, as the experience of pre-Proposition 13 California suggests. In California, voter discontent with local property taxation was fueled by increases in assessments that occurred without proportionate reductions in rates. Assessment increases appeared to drive local revenue increases. The increase in tax bills experienced by homeowners and others derived as much from the failure of local officials to reduce rates as from the upward pressure on assessed valuation produced by rising property values.

What can account for the failure of locally-elected officials to respond to the obvious concerns of local citizens with high taxes? One answer is found in the high costs of "transactions" between individual citizens and elected officials when the burden is placed on individual citizens to seek action from official bodies. If voters are unhappy with steep increases in assessed valuations, in order to keep their tax bills from rising as sharply they must persuade or pressure local governing bodies to reduce rates. The cost of the effort falls on individual taxpayers, who must collectively take their case to elected officials at the appropriate time and place. Such transaction costs are not trivial. Not only do they require that individual citizens become informed about local budget procedures, often in multiple jurisdictions, but they also require that citizens coordinate with one another in order to have a political impact. If citizens fail to show up en masse at public hearings designed to review proposed budgets, officials may conclude that they are free to take advantage of increased revenues without having to raise rates. The cumulative effect of such decisions, however, may be to fuel so-called taxpayer revolts, which simply await the right opportunity for concerted action. Proposition 13 presented California voters with an opportunity to act in a coordinated, low-cost way, to limit the impact of rising assessed valuations.

The same logic that explains the failure of local officials to respond to citizen concerns about the effect of assessment increases on their tax bills provides theoretical support for a requirement of voter consent to rate increases. The question can be framed this way: Who should be required to bear the transaction costs involved in seeking or opposing collective action? Should voters be required to make their case against a tax increase to elected officials, or should elected officials be required to make their case for a tax increase to voters? If transaction costs were too high for voters to be able to make an effective case against higher tax bills caused by escalating assessments in pre-Proposition 13 California, then transaction costs may also prevent voters from making an effective case against increasing tax rates. Requiring elected officials to take their case to the voters redistributes transaction costs to those better able to shoulder the burden, while reserving the decision-making prerogative to those whose pocketbooks and service conditions are at stake.

The use of citizen referenda in this way does not deprive elected officials of significant and important roles in the local revenue-raising process. They remain in the role of community leadership. Many local elected officials will have incentives to function as public entrepreneurs, who function to put together new tax-service packages and seek voter support. Decades of experience with traditional property tax rate limits that allow voter overrides have generated numerous but uncounted instances of successful public entrepreneurship. Although complete data are not available on the use of voter overrides during this latest period of tax limitation, enough is known to draw two important conclusions: (1) Successful voter overrides are not uncommon, but (2) the requirement of seeking voter approval does constrain local governing bodies.

Placing the burden on elected officials to seek tax increases from voters, rather than asking voters to seek tax forbearance from officials, may also offer the advantage of increasing the pressure on local governments to be more efficient. Tax limitation votes in California and Massachusetts prompted local governments to seek out more efficient ways of producing services. The sudden burst of efficiency-seeking activity leads one to ask why such activity did not occur earlier. Local government officials lack the profit incentive of a private entrepreneur, but if they are constrained to behave as vote-seeking public entrepreneurs who must sell specific tax-service packages to the voters, they may be motivated to seek greater efficiency as a means of enhancing the public appeal of a tax-service package. More generally, having to justify tax increases to the voters may cause local officials to be more cost-conscious than otherwise.

Evidence from Missouri also suggests that this combination of rules, like the more onerous limits in California and Massachusetts, prompts an increase in local reliance on user charges. This occurred initially in Missouri despite a rule that required voter approval for virtually every fee increase. The general requirement of voter approval thus changed the composition of the revenue base drawn on by local governments, prompting a shift to user charges even though the rules did not create a bias in favor of the shift. At the same time, however, no great increase in state aids has been forthcoming in Missouri, largely because the rules adopted did not, as in California and Massachusetts, compel reductions in property tax revenues. Instead, the property tax remains within the discretion of local communities to control.

Conclusion

Overall, little evidence exists that TELs have had an appreciable impact on state and local revenues or expenditures. Yet the variety among local fiscal constitutions from state to state is so great that generalization about the effects of limitation is difficult. Four broad patterns can be distinguished. One is to remove the property tax from local discretion. Another is to limit growth according to a fixed percentage, and in still another variant, to limit growth by indexing allowable increments to indicators such as the consumer price index and/or population growth. Finally, three states have redesigned their fiscal constitutions by combining property tax rollbacks with citizen referenda to approve all tax increases. These patterns can be expected to engender quite different outcomes.

Of the four types of fiscal constitution, the structure that combines property tax rollbacks with tax rate referenda seems to offer the best prospect for constraining local taxes and spending without introducing potentially serious fiscal distortions. Each of the other approaches suffers from significant defects. Removing the property tax from local choice--the approach of California and Massachusetts--tends to increase local reliance on state aids, with accompanying distortions in the aggregation of demand for local public goods and services and a reduction in local responsibility for solving local problems. Relying on percentage-based revenue or expenditure limits leads some local jurisdictions, perversely, to increase taxing or spending. Tying revenue or expenditure limits to an external index that reflects the economic environment of local governments would reduce the potential for this type of distortion, but not eliminate it. The fourth approach preserves local discretion over the property tax and focuses local revenue decisions on the property tax rate. Combined with tax referenda, this approach is most likely to constrain local taxing and spending levels to amounts preferred by local citizens.³⁵

³⁵ From Tables 3.1 and 3.3 in the preceding chapter, we learn that combined state-local taxing and spending in Missouri increased both per capita and as a percentage of income from 1978 to 1988. The Hancock Amendment, which included limits on state spending as well, did not operate to reduce, or even hold constant, the overall level of taxing and spending. Measured as a percentage of personal income, Missouri, unlike Wisconsin, is a relatively low-tax state. The history of the state may have created a presumption against the willingness of voters to accept new taxes. (In Wisconsin, the opposite presumption may often have prevailed.) The introduction of tax referendum procedures in Missouri may have encouraged local officials to propose tax increases when ordinarily they would have been reluctant to vote those increases at their own discretion. Tax referenda would seem to reduce the political risk to elected officials associated with raising taxes. In a state or locality where that risk was presumed to be high, switching to referenda may actually increase the likelihood of new taxes. However, if this happens--if local voters approve tax increases that elected officials would not have approved on their own--the result can be considered an improvement in economic efficiency accomplished by removing distortions contained in the process of electoral representation. In Wisconsin, adding voter referenda on tax rate increases would seem more likely to reinforce the recent downward trend in local government spending. Nevertheless, the purpose of letting the voters decide must be to do what the voters say.

RETHINKING WISCONSIN'S LOCAL FISCAL CONSTITUTION

Introduction

The local fiscal constitution in Wisconsin has been based for most of this century on local taxation of property combined with state aids and shared revenues raised statewide and distributed to local governments. Historically, shared revenues originated in tandem with efforts to provide property tax relief. In 1911, when the state enacted an income tax, the same legislation exempted intangibles and household furnishings from the local property tax. Ninety percent of the income tax revenues were to be returned to local governments. The method of distribution used was to return tax dollars either to the jurisdictions within which income was earned or to place of residence for individuals. This same principle was later applied when state assessment and collection of property taxes on utilities was substituted for local taxation and when motor vehicles were exempted from the property tax and subjected instead to a statewide vehicle registration fee.

The principle of revenue sharing on the basis of the jurisdiction of origin was modified in 1971 on the recommendation of a statewide task force.¹ All revenues for distribution to local governments (other than school districts) were consolidated into a single fund. Distribution to local governments would be based on two criteria: (1) population and (2) equalized assessed valuation per capita. Each local government would receive a flat amount per resident plus an equalizing payment based on the relative property wealth of the jurisdiction. The purpose of this new approach was to reduce the variation in property tax rates among local governments by bringing down the highest rates. By 1975, the number of municipalities whose rate exceeded \$30 per \$1,000 of equalized value had been reduced from 657 (in 1970) to 13.² This process was assisted, however, by rapidly increasing assessed valuations.

In 1975, the shared revenue formula for local governments other than school districts was again modified to increase its equalization power, and retains much the same structure today. The formula has three components: (1) a per capita component that consists of a lump-sum payment based on population; (2) a utilities component intended to compensate municipalities for the tax base lost from and services provided to utilities located in their jurisdictions; and (3) an "aidable revenues" component that varies with amounts of locally raised revenue as weighted by the relative size of the local property tax base.

The shared revenue system, nevertheless, retains a strong element of returning tax dollars, not to specific jurisdictions, but to the classes of governments--towns, villages, cities--where those tax dollars are raised. The formula exhibits a pronounced urban bias on the distribution side. Because the formula distributes shared revenues in part on the basis of amounts of revenue raised locally, metropolitan areas with greater service demands³ are able to command a greater proportion of shared revenues. Of course, on the revenue-raising side, urban and metropolitan areas also contribute more in state taxes to support the shared revenue program. The net effect is to distribute revenues roughly in proportion to the types of areas or class of government where those revenues are raised--though not on a jurisdiction by jurisdiction basis as before.

General school aids--state revenues used to support the general education costs of local school districts--have always had an equalization component. Prior to 1973, general school aids were based on a flat amount

¹ Wisconsin Legislative Reference Bureau, *A Legislative History of Shared Revenue in Wisconsin*, Research Bulletin 85-RB-1, January 1985, pp. 15-17.

² Wisconsin Department of Revenue, *Background Paper: Shared Revenue Program*, February 1987.

³ In 1986, towns spent an average of \$177 per resident, villages \$514 per resident, and cities \$681 per resident. Calculated from population and expenditure data in Wisconsin Department of Revenue, *Resources Provided and Expended 1986*, Bulletin No. 86, March 1988.

per student or equalized assessed valuation per student, whichever was greater. Since 1973, the method of distribution has been based entirely on equalization, measured by equalized assessed valuation per student. The former approach set a floor for each district below which general school aid could not fall, a feature that was eliminated by the use of a full equalization formula.

In 1962, the state introduced property tax credits, payments that appear as credits on local tax bills, as an additional means of property tax relief. In the late 1980s, additional property tax relief was provided mostly in this form as opposed to increasing payments to local governments and school districts. The purpose of the shift to property tax credits is to attempt to assure that increases in state support are actually used for property tax relief rather than for increases in local budgets. Most state assistance, however, continues to be supplied as payments to local governments and school districts.

Fiscal Rules/Fiscal Politics

Wisconsin's local fiscal constitution has two basic rules. The first rule is quite permissive: Property tax rates have no legal ceiling. Local governments and school districts are authorized to levy taxes on the allowable property tax base without limitation as to the tax rate (with the exception of Vocational, Technical and Adult Education (VTAE) districts).⁴ The second rule is highly restrictive: Most alternative tax sources are foreclosed. Local governments have virtually no sources of tax revenue other than the property tax (with the recent exception of a county optional sales tax). On the one hand, local governments can access the property tax base without legal limit. On the other hand, local governments cannot make trade-offs among alternative tax bases.

The two basic rules tend to create a perpetual demand at the state level for "property tax relief." Only the state legislature is authorized to respond by making trade-offs among alternative tax bases. Local governments can offer property tax relief only by introducing or increasing user charges--the only other major revenue source within their discretion. As a purveyor of property tax relief, the state has a clear institutional advantage. State legislators are able to address the issue by packaging tax proposals that include a large dose of fiscal illusion, or at least a significant element of uncertainty as to who gains and who loses, while user charges imposed by local governments clearly establish who pays for what. In the presence of high property tax levies, there are powerful incentives for state politicians to raise the issue and assign it a high priority. State legislators in Wisconsin have done precisely this, virtually without interruption, for the past two decades or more.

The demand for property tax relief has led, cumulatively, over a period of some eight decades, to a heavy reliance on state financing of locally demanded goods and services in Wisconsin. Shared revenues are appropriated not to support particular goods and services judged to be of statewide concern, but to provide general support for whatever goods and services local communities want. Similarly, general state aid to education, although targeted to a specific service, supports general education, not selected components of education deemed to be of broader than local concern. Shared revenues and general state school aids are not categorical grants that represent statewide demands for goods and services of broad concern, but subsidies that reduce the local cost of whatever goods and services local jurisdictions choose to provide.⁵

⁴ The state's 16 VTAE districts are limited to a property tax rate of \$1.50 per \$1,000 of equalized assessed valuation for operating costs. Each district is governed by a nine-member appointed board, not directly accountable to the electorate. In 1988, five districts were at the legal limit. Source: Wisconsin Taxpayers Alliance, *Your Wisconsin Government*, Number 8, March 3, 1989.

⁵ Wisconsin also uses categorical grants to support particular objectives--the largest such program being transportation aids. Categorical programs are also used to support selected school programs. The bulk of state assistance to local governments and school districts, however, is distributed as either shared

The reduction in cost is in part fiscal illusion, since the difference is made up in statewide taxes, but in part real--real with respect to those communities that benefit from redistribution due to the state's equalization formulas used to distribute shared revenues and general school aids.

The absence of a ceiling on property tax rates (even a ceiling with an override) means that no local governing body need ever be concerned about approaching a limit. One way to balance the local budget is always to increase the property tax levy by some increment. Small incremental increases spread over all taxpayers in a community may carry a smaller political price for local officials than economy measures that more seriously affect such groups as employees represented by a union or a specific subset of constituents. Incremental increases do not bring local governments any closer to a ceiling when none is there. By contrast, a local jurisdiction subject to a property tax ceiling will have to be concerned about approaching the limit. Alternatives to a levy increase may appear more attractive when it seems prudent to reserve tax rate increases for the most compelling circumstances.

The equalization formulas used for shared revenues and general school aids may also have perverse effects. State support for both local governments and school districts rely on similar formulas that attempt to equalize the property tax base, measured by assessed valuation per capita or per student. In both cases state appropriations determine a standard tax base. Throughout the 1980s, appropriations have been large enough to support a standard tax base well above the average for all local governments and school districts in the state. This means that most local governments and school districts have a tax base, measured in per capita or per student terms, that is lower than the standard base and thus qualify for equalization aid.

The basic structure of both formulas is as follows. The reciprocal of the ratio of a local jurisdiction's tax base to the standard tax base ($1 - \text{the ratio}$) is used as a factor to calculate the amount of the jurisdiction's state aid. A factor has to be multiplied times a base. In the case of local governments other than school districts, the base is the average of the last three years' "aidable revenues," which includes all funds raised from property tax levies plus certain other charges and miscellaneous revenue sources. In the case of school districts, although the story is complicated by a two-tier calculation, the primary base is last year's "shared cost," which includes all operating costs and some capital costs less federal and state categorical grants, as long as this amount does not exceed 110 percent of the statewide average shared cost. In both cases, the more a local jurisdiction taxes per capita or spends per student, the larger is its allocation of state funds (up to a ceiling in the case of school districts). The formulas do not distribute funds solely in inverse proportion to local wealth, but rather, in inverse proportion to local wealth times local taxing or spending.

The effect is to reward most local jurisdictions for spending more and punish them for spending less. Under shared revenue and general school aid formulas, one dollar of reduced spending translates into something less than a dollar of local tax savings. The remaining fraction of the dollar is absorbed by a decrease in shared revenues or state aids. Conversely, one dollar of additional spending requires something less than a full dollar of increased local (own-source) revenues. The structure of both formulas is such as to (1) reduce the marginal cost of providing an additional unit of service and (2) reduce the marginal benefit of finding more economical ways of producing a given level of service. These effects on marginal decisions, much more than the total percentage of local spending financed by the state, threaten potentially to distort the allocation of resources at the local level and dampen investments in innovation aimed at securing greater efficiency in the production of local services. At the same time, the more the state appropriates for shared revenues and general school aids, given the structure of the formulas, the greater the potentially perverse effect on marginal decisions.

Rather than spending restraint exercised locally, local governments and school districts understandably prefer tax relief supplied by the state. The more the state appropriates for property tax relief, the more

revenues or general school aids.

economically attractive become local public goods and services. Local tax levies remain high because increases in shared revenues and general school aids reduce the price of new service increments. This is why Wisconsin's quest for property tax relief resembles a cat chasing its tail. The goal is seductive, and always apparently within reach, but the chase, though renewed at a faster and faster pace, must end in exhaustion.

The source of the problem lies not with the amounts allocated for shared revenues and general school aids, but with distribution formulas that tie amounts received to amounts raised in taxes (or spent) by local jurisdictions. To eliminate the effects that state allocations have on the marginal revenue/expenditure decisions of local governments and school districts, it would be necessary to change the basic structure of the distribution formulas. In place of matching payments that vary with the revenue/expenditure levels of local communities, the restructured formulas must rely on "lump sum" payments to local jurisdictions.

In the two sections that follow, our purpose is to sketch an alternative approach to the distribution of shared revenues and general school aids—one that would rely on lump-sum payments. Because the formulas for the two programs, while sharing the same basic structure, are different in some important respects and present somewhat different restructuring problems, we discuss the two programs separately. We emphasize that the discussion here is only a sketch—not a detailed blueprint. Working out the details of restructured formulas would require much additional research, not to mention policy guidance from the Wisconsin legislature.

Restructuring Shared Revenues

Consider the following basic formula for distributing shared revenues. First, choose an amount of revenue per capita that might be thought of as an appropriate individual entitlement to local government services—an amount that an individual ought to be guaranteed assuming a tax capacity of zero. Call this amount the **BASE ENTITLEMENT**. Then, compute the ratio of actual to standard assessed valuation per capita and take the reciprocal, as at present. This quantity can be considered an **EQUALIZATION WEIGHT**. Multiply the base entitlement times the equalization weight to determine the amount of shared revenue each jurisdiction would receive per capita.

All shared revenues in this restructured formula would be distributed on a per capita basis, but the amount received per capita would vary with the relative size of each jurisdiction's tax base. At present, only a relatively small portion of shared revenues is distributed per capita. Throughout the 1980s, this amount was equal to about \$30 per resident. This feature might simply be retained in the new system, if desired, since it has no effect on marginal decisions.

At present, the standard tax base used to compute the equalization weight is determined annually by the legislature, when it decides on the size of the total appropriation for the shared revenue program. In the restructured formula, a standard tax base should be selected as a point of departure, then modified only to reflect changes in the state's total assessed valuation per capita. Once the initial determination is made, changes in the standard tax base would be made on an objective basis. Instead of varying the standard tax base, base entitlements would be determined by the size of the legislative appropriation. Unlike the standard tax base, the base entitlement, although subjective, has an intuitive meaning. It can be readily interpreted as that amount to which an individual is entitled given a zero tax capacity. The formula then allocates to local jurisdictions an amount per resident that varies with the size of the local tax base and falls to zero as the local tax base approaches the standard base.

For various reasons, it would be inappropriate—most likely inequitable—to use a single base entitlement for all local jurisdictions. One reason stems from variations in the assignment of functions among local governments. Counties have different functions from municipalities, and the distribution of functional

responsibility between counties and municipalities may vary from place to place.⁶ Therefore, it would be necessary to adjust the base entitlement according to some index of functional assignment. Such an index, however, might have reference only to basic functions--those to which individuals might reasonably be assumed to hold an entitlement.

Variation in the performance of basic functions is not, however, the only reason for varying base entitlements. As noted above, the present shared revenue system advantages metropolitan areas--most villages and cities--on the distribution side. Roughly, revenues are returned to the classes of governments--but not individual jurisdictions--in which they are raised. The lump-sum approach sketched here would reallocate shared revenues significantly to rural areas if a single base entitlement were used for all jurisdictions. This result might well be viewed as inequitable.

In distributing shared revenues, the state is virtually required by the nature of economic activity to employ a method of allocation that distributes revenues in a way that has some relation to where they are raised. Tax bases are necessarily associated to some significant degree with demand for services. In non-economic language, tax bases to some extent reflect "need" for services. On a jurisdiction by jurisdiction basis, the relationship between tax base and demand or need is imperfect. This is the problem that equalization programs seek to address. Nevertheless, the greater revenues that can be raised in metropolitan areas from sales and income taxes are associated with greater demands for local public goods and services. This relationship must constrain equalization. Somehow, when the state raises revenues to finance local services, it must distribute funds to types of local governments in at least rough proportion to demand or need for services. The present shared revenue formula in effect uses locally raised revenues to measure demand or need. But this measure is a rubber yardstick that responds to increases in state support by increasing the quantity of locally demanded goods and services.

Therefore, in the restructured formula, base entitlements would have to vary according to local need. Local governments in different socioeconomic circumstances must have different base entitlements. The most obvious approach in Wisconsin would be to vary base entitlements by class of local government. This approach would, however, encounter two problems. One is that class of local government is only imperfectly related to socioeconomic circumstances--this is especially true for towns, which include both rural and urban jurisdictions. The second problem is that tying base entitlements to class of government would offer incentives to change classes--in particular for towns or portions of towns to incorporate as villages. An alternative approach is to use population density as an indicator of basic need. Municipalities could be divided into a number of classes based on population density. Each class would be assigned a different base entitlement. The restructured formula would then treat all local governments with similar population densities (and similar functional assignments) alike, as modified by the equalization weight.

This still leaves the problem of how to determine the base entitlements for various classes, whether local-government classes or population-density classes. The device of imagining what a citizen might be entitled to given a zero tax capacity, while perhaps intuitively useful, does not give us an objective indicator of financial need--it does not generate a number. In the absence of an objective method for calculating a base entitlement, history is likely to be the best available guide. If total state funding for the shared revenue program were set at the current level, base entitlements could then be established for various classes (defined by population density) that would supply each class with the same allocation it had received previously. Local governments within each class would receive, on the average, the same as before. As at present, individual jurisdictions could be guaranteed no more than a 5 percent loss in any one year and precluded from more than a 5 percent gain. This approach would both minimize disruptions from the change to a new system and simultaneously determine a set of base entitlements. Similarly, if the initial

⁶ In the present shared revenue system a county receives only 80 percent of what a municipality with the same aidable revenues would receive.

program allocation under the restructured formula were kept the same as before, the initial standard tax base used to compute the equalization weight would also be set at the level used the previous year.

By using history as a guide, difficulties in introducing the restructured formula can be minimized. Yet the new formula would be more complex, would require more research to implement, and would inevitably cause some complaint from local governments that happen to lose part of their state funding. The potential payoff from restructuring the formula, however, is substantial: A significant increase in local responsibility without sacrificing the principle of equalization. Local communities would be given clear responsibility for growth in local taxing and spending, alongside clear state-level responsibility for maintaining base entitlements.

Restructuring General School Aids

The present formula for distributing general school aids is more complex than the shared revenue formula. There are several differences. Equalization is computed on a per pupil rather than a per capita basis. No general school aids are currently distributed on either a per capita or a flat rate per student basis.⁷ Allocations are based on "shared cost" rather than "aidable revenues," that is, school district allocations are calculated on an expenditure basis instead of a revenue basis. More importantly, the school aid formula includes a ceiling on the amount of shared cost that qualifies for "primary" equalization and introduces a secondary tier of equalization from which districts can actually lose part of their primary allocation.

The use of a ceiling would appear to insert greater fiscal discipline in the case of schools. However, the cap has been generously set at 110 percent of the statewide average shared cost per pupil. In other words, the average district is limited to an increase of no more than 10 percent in its shared cost. In order to receive its full entitlement of general school aid, this district must, in effect, increase its shared cost by 10 percent. School districts spending less than the average districts may increase their shared cost more than 10 percent; districts spending more than the average district, less than 10 percent. In any case, the limit becomes more like a goal--that level of spending necessary to maximize state funding.

Another major difference between shared revenues and general school aids is the much greater functional homogeneity among school districts than among other local governments. Education is viewed in Wisconsin, as in most states, as a state function carried out by local districts. The major functional differences are between districts that offer education for grades K-12 and those that do not. The present general school aid system distinguishes among three types of districts: K-12, union (grades 9-12 only), and K-8, each of which receives a different guaranteed valuation per pupil. Union and K-8 districts are located in the same geographic area.

The general school aid formula can be restructured along the same lines as suggested above for shared revenues. If history is used as a guide for determining initial base entitlements under a restructured formula, all that needs to be done is to change the cap on shared costs to an incremental limit tied, perhaps, to the percentage change in the consumer price index. The limit would be the same for each district, applied to the previous year's primary shared cost (not the previous year's actual cost).⁸ This change would in effect create a base entitlement for each school district (on a per pupil basis), taking present primary shared cost as an initial base, and indexing growth to inflation. It would be necessary to continue varying allocations according to type of school district, either by using different standard assessed

⁷ There are also, however, a number of categorical state aid programs for schools.

⁸ Secondary cost sharing for those costs that, under the current system, exceed 110 percent of last year's statewide average shared cost could either be eliminated or wrapped into the base entitlement for each district.

valuations when computing the equalization weight or by adding a type-of-district weight to the formula.⁹

Addressing the Problem of Local Spending

Restructuring the shared revenue and general school aid formulas to provide for lump-sum payments to local jurisdictions would begin to address the problem of local spending. State equalization efforts would no longer fuel growth in local spending by reducing the marginal cost of providing additional services or by reducing the marginal benefit of local economy measures. At the same time, the state would have crafted a fiscal instrument that it could use in various ways to accomplish its purposes. On the one hand, the equalization power of the formula could be increased or decreased by adjusting the standard tax base. For example, reducing the standard tax base while holding the program allocation constant would disqualify some relatively wealthier local jurisdictions at the margin and increase the base entitlements for the remaining jurisdictions--thus increasing equalization. Increasing the standard tax base would have the opposite effect. On the other hand, the equalization power of the formula can be held constant while varying the total shared revenue allocation, thus increasing or decreasing the level of state support for local governments. In terms of the restructured formula, this would involve increasing or decreasing base entitlements for the various classes of jurisdictions.

The shared revenues program might then be used to address concerns, expressed by the Wisconsin Expenditure Commission, with the aggregate level of local spending relative to personal income. The basic question put to the Commission was to consider how much Wisconsin ought to be spending on state and local government services considering the state's economic profile.¹⁰ If the state legislature were to conclude that its local fiscal constitution has led to inflated local spending, in the aggregate, the restructured shared revenue formula provides a straightforward instrument for addressing that concern: Base entitlements can be reduced, across the board. The decision then falls to local governments whether to make up the difference in locally raised revenues.¹¹ No part of that difference, given a lump-sum method of distributing shared revenues, will be made up by equalization assistance. If the state is concerned about the distributional effects of such a strategy, it can enhance the equalization power of the formula by adjusting the standard tax base downward.

Leaving the decision on replacement revenues up to local governing bodies (other than in towns where town meetings determine the tax levy) may discomfit some legislators. Especially in larger jurisdictions, the

⁹ One might suppose that the restructured school formula also offers a short-cut to restructuring the shared revenue formula for other local governments. Instead of creating classes based on population density, one could simply use present aidable revenues as an initial base entitlement for each local jurisdiction, to be modified annually according to changes in the consumer price index. The difficulty with this approach is that, for local governments in general, changes in population patterns (urbanization) together with changes in functional assignment would more rapidly render historically based entitlements obsolete. The shared revenue formula seems to require a classification method--such as population density classes--subject to change over time, as well as keeping track of changes in functional assignment for basic functions. School districts are much less exposed to this sort of dynamic variation, in part because the formula indexes aid to student population rather than general population. Number of students per capita is a principal indicator of community demand for education. Nevertheless, an on-going research program should be undertaken by the state to monitor selected school costs and compare changes in these costs to changes in base entitlements.

¹⁰ Wisconsin Expenditure Commission, *Final Report*, December 1986, p. 6.

¹¹ Wisconsin's local governments have chosen, overall, to replace most of the loss of federal-aid dollars experienced during the 1980s with local revenues.

transaction costs borne by taxpayers attempting to oppose a tax increase by the local governing body may be quite high. One possibility, then, taking a page from Missouri, Michigan, and Ohio, is to cap property tax rates at the current level and require local governing bodies to seek approval from local citizens in referenda to raise the rate. If there is concern about the effects of assessment increases, rates can be rolled back to compensate for the effects of reassessment. In this manner, local citizens would be asked to decide directly whether to replace lost shared revenues.

In addition to restructuring the shared revenue formula, another possibility worth exploring is to authorize all local governments--not just counties--to enact sales and/or income taxes at local option. This would enable the state to reduce its reliance on statewide revenues to fund local governments. Local-option taxes not only generate property tax relief, but also reduce the variation in tax capacity among local governments. With less tax capacity variation to address, the state would require less money for the purpose of equalization. Moreover, the state would no longer have a virtual monopoly over the supply of property tax relief. Allowing localities to make trade-offs among alternative tax bases would reduce the political demand for property tax relief at the state legislature. If legislators are discomfited by local governing bodies deciding at their own discretion whether to impose a local-option tax, the decision can be left to voters, as done in many states.

Conclusion

It is clear that Wisconsin must rethink its local fiscal constitution if it is to cut short the unending quest for property tax relief and bring fiscal discipline to the provision of local public goods and services. In conclusion, we offer the following observations as benchmarks for further reflection and analysis:

1. Local property taxes are not inherently flawed as a revenue instrument for supporting local governments. Property taxes tend to be benefit-based. Especially if subjected to institutional controls, including reassessment limits to avoid tax windfalls and voter referenda to approve rate hikes, they are a responsive, equitable, and accountable local revenue source. States, such as California and Massachusetts, that have in effect removed the property tax from local discretion have lost an important and useful fiscal instrument--useful both for holding local officials accountable and for expressing local demand for goods and services. Differences in property wealth among local communities can be addressed by a combination of statewide redistribution and local-option taxes on other revenue bases.
2. Neither a large number of local governments nor autonomous local decision-making present obstacles to local fiscal responsibility. There is no "tyranny of small decisions" inherent in processes of local governance. Total local demand for goods and services in Wisconsin can be treated as the sum of demands across all local jurisdictions plus statewide support for equalization, as long as marginal decisions at the state and local levels are independently made. Designing an appropriate local fiscal constitution is more important than determining statewide goals for local taxing and spending.
3. Wisconsin is unlikely to benefit from employing any of the standard approaches to tax and expenditure limitation found in most other states unless changes first are made in the formulas for distributing shared revenues and general school aids. Rather than imposing artificial limits, state legislators should allow local demand to constrain local spending by removing state incentives to spend. The constraint provided by local demand can be reinforced by requiring that voters approve both property tax rate increases and the imposition of local-option taxes.
4. It is not the amount of state financial assistance provided as a percentage of local spending that potentially distorts local decision-making, but rather the way in which state assistance is distributed. Revenue sharing formulas that tie amounts received to local taxing and/or spending levels affect

local decisions at the margin, where increases and decreases are decided, and therefore reduce local responsibility. Lump-sum payments do not affect local decisions at the margin, yet can be calculated to have an equalizing effect.

5. Authorizing local governments to raise tax revenue from sources other than property partially obviates the need for general revenue sharing by reducing variation in tax capacities among local governments and allowing local governments to supply property tax relief. Increasing the number of local tax sources may also increase the potential for fiscal illusion, but no more than relying on shared revenues and state aids.¹²

This report has covered a lot of ground. We began by examining issues in local public finance, and introduced the concept of a local fiscal constitution and considered questions of importance in its design. We then reviewed fiscal patterns in Wisconsin as compared to other states. We examined recent patterns of local taxing and spending in Wisconsin and found those patterns understandable in the context of shared revenue and state aid formulas. We searched for effects from state/local tax and expenditure limitations, both on a 50 state basis and by examining selected cases. Finally, we returned to focus on Wisconsin's fiscal constitution, in view of recent fiscal trends, in order to apply the lessons learned along the way.

The intellectual framework that we used to address these issues--the concept of a local fiscal constitution--suggests a somewhat different approach than offered earlier by the Wisconsin Expenditure Commission. In contrast to the Commission, we make no assumption that Wisconsin should move toward the national average in state/local spending as a percentage of personal income. Instead, we argue that the state's local fiscal constitution does not allow the people of Wisconsin--both as residents of local communities and as residents of the state--to effectively choose the level of state/local spending they want. Statewide goals with respect to local taxing and spending necessarily preempt local responsibility. It is a lack of local responsibility for marginal decisions affecting taxing and spending that accounts for Wisconsin's current dilemma.

Wisconsin, like every other state, is unique. It has followed its own historic path to the present. Having made a commitment to equalization, alongside a strong desire for productive local governments, Wisconsin has found itself paying a lot for local goods and services, relative to income, both through high property taxes and high levels of state assistance, while searching repeatedly for property tax relief. The process is one that feeds on itself. Responding to high property taxes, state legislators increase shared revenues and state aids, which in turn stimulate local spending, which in turn generate upward pressures on property taxes. To find a way out of this political-fiscal cycle, Wisconsin must look toward greater local responsibility for fiscal decisions at the margin. Fortunately, this can be done without diminishing state responsibility for equalization.

¹² State aid for local functions that are not basic functions performed by nearly all local governments is best provided by means of categorical grants. Jurisdictions that do not perform the function then do not receive the aid.

ABOUT THE INSTITUTE

The Wisconsin Policy Research Institute is a not-for-profit institute established to study public policy issues affecting the state of Wisconsin.

Under the new federalism, government policy increasingly is made at the state and local level. These public policy decisions affect the lives of every citizen in the state of Wisconsin. Our goal is to provide nonpartisan research on key issues that affect citizens living in Wisconsin so that their elected representatives are able to make informed decisions to improve the quality of life and future of the State.

Our major priority is to improve the accountability of Wisconsin's government. State and local government must be responsive to the citizens of Wisconsin in terms of the programs they devise and the tax money they spend. Accountability should be made available in every major area to which Wisconsin devotes the public's funds.

The agenda for the Institute's activities will direct attention and resources to study the following issues: education; welfare and social services; criminal justice; taxes and spending; and economic development.

We believe that the views of the citizens of Wisconsin should guide the decisions of government officials. To help accomplish this, we will conduct semi-annual public opinion polls that are structured to enable the citizens of Wisconsin to inform government officials about how they view major statewide issues. These polls will be disseminated through the media and be made available to the general public and to the legislative and executive branches of State government. It is essential that elected officials remember that all the programs established and all the money spent comes from the citizens of the State of Wisconsin and is made available through their taxes. Public policy should reflect the real needs and concerns of all the citizens of Wisconsin and not those of specific special interest groups.