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Financing Central Cities: The Economics Underlying Fiscal Strategy Options

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Financing Central Cities: The
Economics Underlying Fiscal
Strategy Options
With Special Reference to Syracuse City and
the Consensus Report

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Abstract

A consortium of Syracuse City and Onondaga County governments along with a number of local area non-profit organizations have recently organized a commission on Local Government Modernization for the Syracuse area. The Report makes three major recommendation to strengthen the local public sector in the Syracuse region: seek opportunities to share public services across local jurisdictions to reduce costs, adopt the Minneapolis region model for sharing revenues from new commercial and industrial development across localities, and work toward merging Syracuse City government with Onondaga County government. At the same time, current non-city residents would not have responsibility for the city or school district's legacy debts or post-employment benefit obligations.

The working paper reviews the urban economics and local public finance literature in the context of fiscal viability of central cities. Central cities form the heart of knowledge-based economies and those benefits redound to the entire region in the form of higher property values and incomes. In addition, suburban enclaves have developed in part through discriminatory policies and practices at the federal and local levels and they have weakened the fiscal viabilities of central cities. It also reviews the relevant local public finance literature on city annexation and government mergers, optimally sized jurisdictions, non-profit entities' payments in lieu of taxes in cities, efficient local government taxes, and related topics. Based on the review, the economic development of a region depends on the economic and fiscal sustainability of its central city. Suburban resident benefit in tangible ways from the economic activities in their respective cities and suburban areas could reasonably devote a portion of their tax base to enhance the resources available to the city to service the city's legacy debts and other obligations. The working paper concludes with fiscal implications for Syracuse City and its metropolitan area.

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Introduction

A consortium of Syracuse City and Onondaga County governments along with a number of local area non-profit organizations have recently organized a commission on Local Government Modernization for the Syracuse area. The group has issued a report entitled, “The Consensus Options Report and Preliminary Committee Recommendations” (The Report) that reflects considerable thought and effort. The committee has performed a valuable service to the Syracuse region and New York State. It frames well a number of unresolved fiscal challenges that face our region and many others; that is, challenges that have resulted in part from a secular change in the region’s traditional manufacturing economy to a knowledge-based and service economy. These changes have left workers in the community behind, while others have left the region and State.

At the same time, metropolitan areas have experienced migration of more affluent households from residential locations within cities to suburban enclaves. The results in this region and many others are regional landscapes that look like a patchwork of well off and fiscally sound suburban towns and municipalities interspersed with less well-off areas. Central cities often have concentrations of low-income households, decaying infrastructures, underperforming local city schools, and an inability to break out of a downward fiscal spiral without a fundamental shock to their fiscal systems and/or the regional governmental structures.

A recent Urban Institute report confirms that the Syracuse area’s poorest census tracts have lost income in nominal terms in the 20 years between 1990 and 2010, while the areas highest income tracts within the region have experienced income gains, widening the gap between its affluent and poor tracts/neighborhoods.¹ Moreover, the poorest tracts in the region are in Syracuse City and its affluent

¹ Pendall, Rolf and Carl Hedman. *Worlds Apart: Inequality between Americas’ Most and Least Affluent Neighborhoods.*” Research Report, Urban Institute, June 2015.

tracts lie outside of the city. According to the same report, the above trends follow that of other rust belt areas from Buffalo to Milwaukee where their lower-income tracts experience declines in income levels while their highest income tracts experience income growth with the former lying inside the central cities and the latter in the cities' suburbs.

This "locked-in" pattern of concentrated poverty hampers a central cities' economic recovery and likely reduces their attractiveness to a workforce of innovators that is so important to economic development in the new economy.² Fiscal stress and persistent fiscal challenges for central cities ensue.

This report reviews the urban public finance literature relevant to addressing fiscal stress in central cities. Before doing so, it is useful to summarize the major recommendations of the Syracuse Consensus Report.

Consensus Report Recommendations

The recent Consensus report responds in part to the fiscal stress of the Syracuse City. Focusing on the Economic Development and Governance sections, The Report makes a number of important observations.

1. Despite population decline overall in the region since 1970, the amount of urbanized area in the region since 1970 has increased 92 percent. (See page 59). The urbanization has required new infrastructure development while the region's overall population has not grown. The foregoing point is reinforced on page 67 with specific information on the significant number of new water mains and the miles of new sewer lines installed, and roads laid since 1970.

²Jacobs, Jane. 1969. *The Economy of Cities*. New York: Vintage Books 262 pages; and Edward L. Glaeser and Joshua D. Gottlieb. 2009. "The Wealth of Cities: Agglomeration Economies and Spatial Equilibrium in the United States." *Journal of Economic Literature*. 47 (4): 983-1028.

2. The Report notes (page 66) that an absence of an enforceable regional land use plan has exacerbated incentives for municipalities in the region to engage in intra-regional competition for job growth and to think in terms of zero-sum economic growth within the region.
3. The Report sets an objective “to incentivize future development in all parts of the region in a way that preserves fiscal benefits for all municipalities.”
4. The Report also recommends Combining City and County Industrial Development Agencies and economic development offices to create one professional, fully accountable and transparent development agency (page 68).
5. The Report notes that 69 percent of the employed population of the region works in a different municipality than the municipality where they reside (page 69).
6. The Report supports adopting the Minneapolis-St. Paul areas tax base sharing formula to share 40% of new commercial and industrial property value among municipalities based on their respective fiscal capacities.
7. The Report recommends that Syracuse City and Onondaga County as well as other municipalities in the region develop shared services models to deliver local public goods and services at lower costs.
8. The Report contains a recommendation to merge the city and county governments and lays out potential cost savings that would result from more efficient delivery of local public services.
9. Whatever merger occurs in item 7, the report leaves in place and unresolved the City’s long-term debt obligations and financial responsibilities for post-employment benefits, primarily health insurance (pages 90-91).
10. The proposed merger also leaves in place the City School District’s obligations to finance post-employment benefits and to finance its debt (pages 90-91).

The report's major recommendation to share public services between Syracuse City and Onondaga County focuses on cost savings that result from shared services and/or a city and county merger. It stops short, however, of solving the fiscal problems that confront the City of Syracuse. It also leaves in place the areas many small municipalities.

The merger idea and shared services lies at the intersection of a large number of studies on both the important economic roles that cities and metropolitan areas play as centers of employment and innovation as well as state and local public finance. Urban public finance covers a wide number of topics that include: the productivity of cities and its implications for property values; the population and employment decentralization from cities to suburbs; well-designed fiscal systems to finance local public services; the optimal size of local government jurisdictions; and what responsibilities, if any, suburban residents have to their respective central cities. The analysis herein focuses on urban public finance literature and potential rationales for intervention into the fiscal systems of central cities. It also addresses how a number of central cities have altered their tax and expenditure structures to keep their central cities on solid fiscal footing. The last section of the paper discusses implications for Syracuse City.

As a note of clarification, decentralization of people and jobs from central cities along with the transformation of the national economy from a manufacturing-based employment structure to a service-based employment structure lie in the background of the discussion below. Many of the issues that confront cities have their origins in the decentralization of jobs and people from the city centers. Aspects of decentralization and its origins and implications are discussed below. A full discussion of the transformation of city life in the 20th century is beyond the scope of this paper.

Cities and Metropolitan Areas as Economies

A long list of analysts and scholars have recognized that cities and metropolitan areas represent economies that provide jobs and stir innovation. The authors of this literature are too numerous to cite in this paper, and I review the topic, citing only a few of the giant figures in this field. Agglomeration economies represent a major theme and create a rationale for firms to cluster in cities and metropolitan areas. Agglomeration appears in much of the early economics literature. Alfred Marshall noted in his writing that firms in similar industries could add productivity when they cluster or locate near one another. Clusters of firms lead to productivity enhancements for a number of reasons: they attract labor forces that can work in many of the firms thereby making labor markets and job matching more efficient for firms and workers; each firm in the cluster can specialize in the production of a particular component of a product that is jointly produced within the cluster and operate more efficiently; firms transfer technologies and production know-how among the firms; as well as other sources of productivity enhancement. Jane Jacobs extended the notion to city clusters of people who transfer knowledge to one another through social and worker interactions and create new knowledge that enhances productivity.³ Marshallian economies form the basis of cities and Jacobian economies reinforce the basic idea and extend it to knowledge economies, such as education, health care, and technology industries.

If the clustering of firms and people only occurred in central cities and people lived near where they worked, the wealth of cities would correspond to their fiscal responsibilities for local education and other local public services to their respective populations. For reasons, discussed in the next segment, the alignment of economic wealth and fiscal obligations to city populations no longer applies in many

³ Jacobs, Jane. 1969. *The Economy of Cities*. New York: Vintage Books 262 pages; and Edward L. Glaeser and Joshua D. Gottlieb. 2009. "The Wealth of Cities: Agglomeration Economies and Spatial Equilibrium in the United States." *Journal of Economic Literature*. 47 (4): 983-1028. Moretti, Enrico. 2012. *The New Geography of Jobs*. NY: Houghton, Mifflin, Harcourt. 294 pages.

cities. Many cities, once the center of economic activity in the region, retain importance as innovation centers within regional economies; however, transportation and other factors have decentralized people and jobs to areas outside the city.

Decentralization of Populations from Central Cities.

The flight of populations from city centers dates at least to the era following World War II. The advent of inexpensive transportation in and out of the city made it possible for families to move to single-family housing located on larger plots of land in the suburbs. Models of urban structure examine a monocentric city (a central city) with residents living at various distances from the center city and commuting to the center for employment.⁴ With income elasticities of demand for land that exceed increases in the disutility of commuting longer distances from the suburbs to the city center, the models show how higher-income residents with high demands for land move to suburban locations and outbid lower-income households for land/locations in the suburbs. The models offer an explanation for the observed of flights of higher-income households from the central city to the suburbs with lower-income households demanding housing in the central city and locating nearer to public transit facilities available in the city.

Around the same time as the urban structure models emerged, Tiebout develops the idea that households locate in homogeneous clusters around their demands and preferences for local public goods.⁵ Essentially, households vote with their feet to achieve an efficient combination of local taxes and local public goods. The quality of local public schools represents a major public good and suburban

⁴ See, for example, Alonso, William. 1964. *Location and Land Use*. Cambridge, MA: Harvard University Press, Mills, Edwin S. 1972. *Studies in the Structure of the Urban Economy*. Baltimore, MD: Johns Hopkins Press, or Muth, Richard. 1969. *Cities and Housing*. Chicago, IL, University of Chicago Press.

⁵ Tiebout, Charles. 1956. "A Pure Theory of Local Expenditures." *Journal of Political Economy*. 64: 416-424.

enclaves often form within and around school districts that have particular quality characteristics. The models of urban structure above and the Tiebout model, while competing as explanations for urban decentralization, can lead us to the same observed decentralization patterns where relatively high-income households with homogenous demands for local public goods locate away from the city, and lower-income households remain in the city.

Wheaton examines whether the demand for land or the demand for public goods dominate as explanations for the urban decentralization patterns observed for one urban area - San Francisco in 1965.⁶ Wheaton's estimates of income elasticity of demand for land and parameters for the disutility of commuting suggest that the demand for land has not motivated decentralization in his sample. Rather, he concludes, "the suburbanization of America's middle and upper classes is a response to housing market externalities and the fiscal incentives of municipal fragmentation."

Evidence from one city in one period does not provide conclusive evidence on the reasons for decentralization. Hamilton shows how, with fiscal zoning in urban locations, the property tax serves as a benefit tax for local public goods, adding more weight to Wheaton's conclusion.⁷ Subsequent studies - Fischel and later Lutz - of zoning and its effect on property values indicate that households bid up the price of land when zoning works to create areas where households match more closely their demands for local public goods and property tax payments.⁸ These studies lend empirical support for Wheaton's conclusion, and lead Fischel and Oates to conclude that the property tax, at least in urbanized areas, acts

⁶ Wheaton, William C. 1977. "Income and Urban Residence." *American Economic Review*. 67: 620-31.

⁷ Hamilton, Bruce W. 1975. "Zoning and Property Taxation in a System of Local Governments." *Urban Studies*. 12: 205-211.

⁸ Fischel, William A. 1990. *Do Growth Controls Matter?* Lincoln Institute of Land Policy. Cambridge, MA. Lutz, Byron. 2015. "Quasi-experimental Evidence on the Connection between Property Taxes and Residential Capital Investment." *American Economic Journal: Economic Policy*. 7: 300-330.

as a benefit tax that charges residents for the local public goods they consume.⁹ Broadly, income growth and demand for new housing, lower commuting costs, better matches between local public goods and employment decentralization into the suburbs have accelerated population decentralization.¹⁰

A related set of studies finds that, while zoning can lead to efficient local public good outcomes, local officials have also used zoning to exclude certain groups from suburban areas based on race and income. Discrimination in mortgage lending through redlining neighborhoods (Ross and Yinger) and seller intermediaries steering certain minority families away from white neighborhoods (Yinger) has reinforced white enclaves and decentralization.¹¹ Rothstein make a case that public housing policy by design - de jure discrimination - has excluded minorities from FHA loans and from certain types of public housing with the express purpose of keeping minorities out of the suburbs.¹² Bloustan also offers evidence that racial discrimination in housing markets and other practices have significantly reduced the number of non-white and/or lower-income households that can reside in suburban areas. She concludes that white flight to the suburbs as a response to black in-migration from the South into Northern cities contributes to concentrations of lower-income residents in central cities.¹³

⁹ Oates, Wallace E. and William A. Fischel. 2016. "Are Property Taxes Regressive, Progressive or What?" *National Tax Journal*. 69: 415-34.

¹⁰ Bloustan, Leah Platt. 2017. *Competition in the Promised Land*. Princeton, NJ: Princeton University Press: page. 101.

¹¹ Ross, Stephen L., and John Yinger. 2002. *The Color of Credit: Mortgage Lending Discrimination, Research Methodology, and Fair-Lending Enforcement*, Cambridge, MA: MIT Press. Yinger, John. 1986. "Measuring Racial Discrimination with Fair Housing Audits: Caught in the Act." *The American Economic Review* 76: 881-893.

¹² Rothstein, Richard. 2017. *The Color of Law*. New York: Liveright Publishing Corporation, A Division of W.W. Norton and Company. 345 pages.

¹³ Bloustan, Leah Platt. 2017. *Competition in the Promised Land*. Princeton, NJ: Princeton University Press 197 pages.

Through a variety of forces described above, many central cities house lower income groups with high local public service needs. Cities often encounter structural fiscal imbalances and typically encounter long-term fiscal challenges.

At the same time, the economy of the United States and the economies of cities have changed. Employment in manufacturing has declined relative to manufacturing output due largely to technological change. The economy has shifted to services - the largest of which are housing services, health care services and education services. Knowledge and learning constitute a major element of these industries, and many cities serve as centers for the so-called “eds and meds” service industries. In addition, many education and health care firms have non-profit status and have exemptions from property tax payments, leaving cities without tax revenue sources from either the non-profit firms or its workers who often live outside the city. These fiscally challenged cities may provide agglomeration economies that foster growth of incomes and property values of suburban residents.

As noted above, market forces distorted by discrimination and other policies have led to suburban enclaves, which also serve suburban residents’ preferences for non-redistribution of local taxes and services toward low-income households by blocking their entrances to suburban areas. The discriminatory policies themselves may form a rationale for intervening to help central cities.

A number of central cities have overcome the fiscal implications of flight to the suburbs and have expanded tax bases through annexation of their suburban areas. In fact, cities in the United States that have maintained the most robust fiscal health have annexed their suburbs.¹⁴ Annexations represent one way for central cities to capture suburban tax capacities. City annexations have different characteristics

¹⁴ Rusk, David. 2006. “Annexation and the Fiscal Fate of Cities.” *The Brookings Institution, Metropolitan Policy Program*. August 2006: 25 pages.

in both the extent of the areas annexed and the ease with which cities may annex their suburban jurisdictions. In addition to annexations, 13 cities have formally merged with their surrounding county areas. The next section of the paper examines annexations or mergers in more detail.

City Annexations

Cities' annexation of their suburbs has a long history; occurs frequently; and continues to the present. Rusk reports that the land area for the 566 cities in his study has tripled to 31,304 square miles in the year 2000 from 10,604 square miles in 1950. About 70 percent of the expansion of city boundaries has occurred through annexation in 309 of the 566 cities. The report notes that cities that have annexed their suburban areas have much stronger fiscal health than cities that do not or cannot annex.

The ability of cities to annex their adjacent suburban communities or unincorporated areas varies by region of the country. Many states recognize independent cities only in urbanized areas, and so-called "Big Box" cities - in Rusk's terminology - can annex unincorporated suburbs with relative ease. According to Rusk, 296 of the 566 cities in his analysis fit this category and they account for 62 percent of the expanded land area of cities between 1950 and 2000 (Rusk, 2006, Table 4, page 9).

Annexation occurs most frequently in the Southern and Western areas of the United States with the exception of California. By contrast, cities in Northeastern States as well as New York, New Jersey and Pennsylvania have adjacent independent incorporated suburban cities, and annexation requires suburban residents' approval through voter referenda. Suburban voters rarely approve city annexations. Consequently, some cities find it difficult to annex their suburbs, and as a result, cannot expand their tax bases via annexation.

Another 24 percent of the expanded land areas of cities has occurred in the 13 city/county consolidations since 1952. Two city/county consolidations occurred in Virginia - the first in 1952 and

the second in 1957. Two more consolidations - Nashville City with Davidson County in TN in 1962 and the second in Jacksonville City with Duval County in FL in 1967 - are better known. The most recent city-county merger is Louisville City with Jefferson County in KY in 2003.

Among the city/county mergers, there is variation in whether or not the school districts within the county also merge. Nashville-Davidson and Jacksonville-Duval merge the school districts for fiscal purposes and fund them on a countywide basis. The most recent merger, Louisville-Jefferson County, also consolidates the school districts within Jefferson County.¹⁵

Consolidation and Annexation Challenges: The Case of Louisville

A brief review of the Louisville-Jefferson County consolidation highlights the citizens' concerns typically associated with local government consolidations and mergers. Wachter evaluates the Louisville-Jefferson County merger after ten years and discusses the objections voiced during discussions of and meetings about the merger.¹⁶ Suburban residents at the time expressed concern that they would experience property tax increases to pay for public services that did not benefit them, while public employee unions conveyed apprehension about losing bargaining power. The African-American community articulated uneasiness about adequate representation of their interests in a city/metropolitan government. The LGBT community voiced disquiet about losing representation in government and about slipping in the progress they had made on non-discrimination in the workplace.

City-county or metropolitan area mergers also have the potential to reduce property values in areas of counties where mergers increase property taxes and/or upset close matches between property

¹⁵ The Jefferson county and Lexington Kentucky school districts were merged in 1975 by court order. The merger occurred because of a lawsuit on the continued segregation of schools in Lexington and the surrounding county. See Jeff Wachter, "A 10-Year Perspective of the Merger of Louisville and Jefferson County, KY: Louisville Metro Vaults from 65th to 18th Largest City in the Nation. Report dated September, 2013. <http://www.abell.org/sites/default/files/publications/cd-louisvillemerger1013.pdf>

¹⁶ Wachter op cit. pages 4-6.

taxes paid and local service benefits. Changes in the menu of local schools in neighborhoods also have the potential to alter housing prices, especially where consolidations lead to reductions in spending on local schools. School spending was not a concern in Louisville-Jefferson County, because the school districts in the county and the city had already merged in 1975 by court order. The school district merger component of property value capitalization had already occurred. Loss of local autonomy, however, is both a general concern in merger decisions and a concern in Louisville.

Confident that the merger would produce cost efficiencies in public service provision, the Louisville merger proponents promised to maintain property taxes at or below pre-merger levels in each small city. Residents and businesses within Louisville City continued to pay higher pre-merger property taxes to support services received within the “urban district.” The government structure set up a mayor and a metro council consisting of 26 members who represented 26 districts in the county. Nonetheless, considerations about appropriate representation of communities in the new government structure and merger of certain services met with opposition and required negotiation.

The above set of concerns are raised in any merger, but residents’ first consideration is the fiscal implications and residents’ unwillingness to pay for services that do not benefit them. To put it more technically, the merger has the potential to reduce Tiebout efficiency, where under the merger, public services and taxes less closely align, as they may have within former jurisdiction boundaries.

The above concerns about economic efficiency (benefits of services/tax costs) raise important questions about the tradeoffs between having smaller local government jurisdictions meeting more precisely the public service demands of a relatively small number of households or businesses and the potential gains from forming larger local government jurisdictions. The next section of the paper contains a brief review of the tradeoffs or considerations for optimal local government jurisdiction sizes.

How Large Should Local Government Jurisdictions Be?

Wallace Oates models the most important economic and political gains and losses involved in decisions about the size - smaller (in population) versus larger - of local government jurisdictions.¹⁷ First, the smaller the local government jurisdiction, the more closely the local public goods supplied match the residents' demands for local public goods and services. Smaller jurisdictions tend to have populations that are more homogeneous and the match between their demands for local public services and taxes paid more closely resemble Tiebout efficiency discussed in above segments of this paper. By contrast, larger jurisdictions tend to have heterogeneous populations and less efficient matching of residents' demands for local public services with their tax payments. Matching citizen public goods demands to their tax payments is economically efficient (demand = supply) and favors smaller local government jurisdictions.

Local goods, once provided however, can benefit citizens who do not live in the particular municipality and fiscal spillovers to other jurisdictions imply that residents of neighboring jurisdictions receive benefits of local public goods - roadways, public parks, government sponsored events, sanitation, police and other services. With fiscal spillovers, residents in other jurisdictions consume local public goods when they visit or work in jurisdictions other than the jurisdictions in which they reside. Large fiscal spillovers imply that local public goods are underprovided and larger local government jurisdictions are indicated to internalize (minimize) the fiscal spillovers.

Two other considerations enter Oates' model. Larger jurisdictions with more people and heterogeneous preferences for local public goods generally mean higher decision costs when allocating services or deciding how much service to provide in each area. On the other hand, to the extent that

¹⁷ Wallace E. Oates. *Fiscal Federalism*. Harcourt Brace and Jovanovich, 1972 pages 31-53.

economies of scale occur for public service delivery, larger local government jurisdictions can deliver services at lower per person costs.

The optimal size jurisdictions amounts to a tradeoff among these four considerations. Decision costs and local preferences push toward smaller population-size jurisdictions, while fiscal spillovers, and the potential to reduce costs, pull toward larger population-sized jurisdictions.

The optimal size jurisdiction can vary with the type of public service and with demand characteristics of the particular area. It is impractical to have a different size jurisdiction for each local public service, although fragmented and overlapping local jurisdictions in many instances characterize local governments. Areas where populations are relatively homogeneous in large portions of a county will find that the decision costs will not increase significantly nor will the match between public service preferences and local taxes be upset in a larger jurisdiction. In these cases, the advantages of larger jurisdictions will likely outweigh the benefits of smaller jurisdictions.

Efficient Local Taxation

Economic efficiency in local public finance implies that residents and businesses located in a local government jurisdiction have no incentive to leave for a better fiscal package in another jurisdiction. Abstracting from the fiscal challenges of cities, Inman has explicitly laid out an economically efficient system of local government taxation; one that departs significantly in some cases from the tax bases that local government typically use. Note that the traditional local government tax sources include source-based-taxes on sales, employees' wage taxes or income taxes, regardless of residence, property taxes on

business capital, and gross receipts taxes, or in general, residence-based tax systems on residents' income and property.¹⁸

Instead, Inman's system matches local taxpayers' payments with the benefits of the local services they receive. His system does not rely on zoning or restrictive housing patterns. Efficient financing would charge residents for public services through user charges and residence-based property taxes. Businesses would pay for public services through user charges and land-value taxation. Similarly, commuters to the city for employment pay user charges for services, and visitors from out of town and visitors from the local area who consume culture and entertainment would pay hotel and entertainment taxes to compensate cities for public services. The tax system that Inman proposes approximates a benefit tax/charge approach to local public goods, making the system a benchmark for economic efficiency. Using Inman's efficient fiscal system stems the incentives for residents and businesses to leave the city for fiscal reasons, while at the same time, it compensates the city for services it provides to commuters and visitors.

There is limited scope in the efficient fiscal system for charging one set of residents for services they do not consume or for subsidizing (redistribution to) lower-income populations. Inman maintains that redistribution of income or services at the local level will fail because mobile middle- and high-income households can avoid redistribution within a local government by moving to other local districts in their area. In his schema, state or federal governments finance services for cities' populations that have public

¹⁸ Inman, Robert P. 2009. "Finances: Financing City Services." In Robert P. Inman (Ed). *Making Cities Work: Prospects and Policies for Urban America*. Princeton N.J.: Princeton University Press. Chapter 11, Pages 328-361.

service needs that exceed their capacities to pay. Similarly, state and federal governments finance transfer payments to households.¹⁹

Fiscal Implications for Central Cities

The foregoing discussion about efficient taxation and the economic efficiency inherent in small suburban jurisdictions leaves few fiscal options for central cities that cannot annex suburban communities or receive adequate federal and state support to service low-income populations. In these central cities, taxes bases have dwindled, and even with modest revivals of downtown areas, central cities that cannot push their boundaries into the suburbs face fiscal challenges for the foreseeable future. Mergers of cities and counties, as well as shared services arrangements among local governments, can bring down future costs of government. However, as noted above, in the recently released “Consensus Options Report for the Syracuse Region” merged governments are very reluctant to take on the responsibility for cities’ accumulated debts and known future obligations for “other post-retirement benefits” - health insurance. (See page 90 of The Report.) The discussion of the Louisville-Jefferson County merger illustrates the general concerns that residents have about post-merger tax increases to pay for services received by others in the expanded jurisdiction.

On the other hand, cities made their legacy financial commitments during different economic times, and cities will need to find relief through the state or even bankruptcy measures, such as in Detroit. At the same time, it does raise the question of what benefits suburban residents derive from the central cities, or put more starkly, would suburbs thrive less in the absence of the economic benefits afforded by

¹⁹ For an earlier discussion of benefit taxes in suburbs and central cities, see Bradford, David F. and Wallace E. Oates. 1974. “Suburban Exploitation of Cities and Governmental Structure.” In *Redistribution Through Public Choice.* H. Hochman and G. Peterson editors. New York: Columbia University Press. Pages 43-90.

their respective central cities. The answer to the question may depend on the particular city and its MSA area outside the city. Nonetheless, there are some general points that come from the research on cities and then some particulars about Syracuse City.

There are three general points. Do benefits of central cities enhance suburban property values? How might cities be compensated for a large amount of non-taxable property for non-profit hospitals and higher education institutions that employ non-city residents? Third, as documented in recent studies, explicit policies have contributed to the large-scale population decentralization of cities and the concentrations of poverty in central cities. In the absence of such policies, our suburbs and central cities might look very different. I explore the first question in the next section of the paper.

What Do Central Cities Contribute to Their Suburbs?

As already noted, central cities produce agglomeration effects - both Marshallian and Jacobian - that raise the productivity and income produced in cities. In turn, earnings of workers increase and housing prices rise in the cities and the same may occur for the cities' respective suburban residents. The latter effect intertwines the fate of the suburbs with the economic success and fiscal viability of their respective central cities. Voith examines whether cities' productivities induce population, housing value and income growth in suburban areas.²⁰

Voith indeed finds that income growth in central cities in turn leads to growth in incomes, housing values and to some extent population in their suburbs. The effects are strongest for cities with populations above 500,000 in 1990; significant for cities with 1990 populations between 300,000 and 500,000; and not statistically significant for cities with populations below 300,000.

²⁰ Richard Voith. "Do Suburbs Need Cities?" *Journal of Regional Science*. 38 (2) 1998: 445-464.

Haughwout and Inman extend Voith's analysis.²¹ They cite a growing literature on the importance of agglomeration economies. Indeed a large amount of research confirms that agglomeration economies in cities benefit their regions/MSAs.²² Even while industries decentralize from cities, important industries such as large research universities, health care and financial services often realize agglomeration benefits from concentrating in central cities.

Their analysis establishes links between concentrations of poverty in cities as well as high tax prices in cities and housing appreciation and income growth in both cities and their surrounding suburbs. Higher concentrations of poverty and higher taxes in cities reduce agglomeration and the productivity of cities and redound to lower housing appreciation and income growth in both cities and suburbs. Moreover, the effects of poverty concentrations and higher tax prices are larger when the central cities lie in MSAs with populations larger than 250,000.

Another important finding is that the presence of research universities in central cities adds 9 percent to city housing values and 5.4 percent to suburban housing values over a decade. It also increases city residents' income growth by 3.5 percent and suburban residents' income growth by 2.1 percent over a decade. (Table 4). Interestingly, the presence of research universities in the suburbs has no effect on housing values or incomes in either the cities or the suburbs.

²¹ Haughwout, Andrew F. and Robert P. Inman. 2002 "Should Suburbs Help Their Central City?" *Brookings-Wharton papers on Urban Affairs*: 45-94.

²² Ciccone, Antonio and Robert Hall 1996. "Productivity and the Density of Economic Activity." *American Economic Review*. 86: 54-70. Henderson, Vernon, Ari Kuncoro, and Matt Turner. 1995. "Industrial Development in Cities." *Journal of Political Economy* 103 (October): 1067-90. Rosenthal, Stuart and William Strange. 2003. "Geography, Industrial Organization, and Agglomeration." *Review of Economics and Statistics*. 85: 377-393. Moretti, Enrico. 2012. *The New Geography of Jobs*. New York: Houghton Mifflin Harcourt 294 pages.

Haughwout and Inman's empirical evidence establishes a case for the interconnectedness of the cities and their suburbs and for suburban residents maintaining strong central cities based on self-interest in housing appreciation and income growth. Haughwout and Inman make recommendations about aid to central cities to maintain fiscal health that enhance their attractiveness for industry concentrations. State aid should fund state-related mandates to address poverty. Tax base equalization within each metropolitan area could also replace lost revenues due to the high concentrations of poverty in central cities. It would also remove some incentives for population decentralization, as even with modest tax base sharing suburban enclaves would lose some of their fiscal advantages. They also recommend restricting application of the property tax to residential properties and not levying the tax on businesses. Instead, businesses would pay user fees for city services.

Implications for the City of Syracuse

Residents of the Syracuse metropolitan area enjoy a number of economic benefits from the City of Syracuse. The City provides a valuable employment base; has a cultural vibrancy; features major transportation arteries; houses the region's major hospitals as well as a significant portion of specialized outpatient medical care; hosts a major research university; and affords numerous other amenities to residents of the region living outside the city. Indeed, 59 percent of the people who work in the City live outside the City and pay property taxes to another municipality. From another perspective, 28.4 percent of those living outside Syracuse City and within the Syracuse metropolitan area work in the City of Syracuse.²³

Based on the Haughwout and Inman's empirical results, residents in the suburbs of Syracuse experience higher growth in property values because of the industry agglomeration effects in Syracuse City. They estimate that the presence of a major research university in the city alone adds 5.4 percent to housing values in the suburbs over a decade. The health center complexes, although not explicitly studied in Haughwout and Inman, likely add additional housing value and income growth to suburban residents.

Combining Shiller's data on home price increases (3.6 percent annually on average in the U.S.) with Haughwout and Inman's results on the influence of a city-based research university on suburban home prices, a research university contributes 12.5 percent of the overall increase in home prices over a

²³ Figures are based on the commuting data from American Community Survey in 2010. The data is available through IPUMS-USA. Steven Ruggles, Katie Genadek, Ronald Goeken, Josiah Grover, and Matthew Sobek. Integrated Public Use Microdata Series: Version 6.0 [dataset]. Minneapolis, MN: University of Minnesota, 2015. <http://doi.org/10.18128/D010.V6.0>.

decade.²⁴ Housing prices in smaller metropolitan areas grow more slowly than the national average. As a working number, I use 2.0 percent as the annual housing price growth in Syracuse's suburbs. At that rate of annual growth, housing prices increase in the Syracuse's suburbs 22 percent in a decade and a research university located in Syracuse City contributes 12.5 percent of that growth in housing prices. Put another way, the presence of a research university adds 2.75 percent to housing price growth or in the absence of a research university, housing prices would grow 19.75 percent instead of 22.0 percent over a decade.

The increment in property value growth due to the city hosting a major university is analogous to the effect that a major capital improvement has on suburban home prices. Improvements in public infrastructure - transportation that reduces commuting time, for example - increase property values. To help pay for infrastructure improvements, cities have used tax increment financing - sometimes known as valorization taxes.²⁵ Housing a major research university as well as non-profit or government-sponsored medical school and hospital complexes enhances property values in the region. The fact that these facilities have tax-exempt status creates additional rationale for compensating the city.

To implement the valorization or tax-increment finance plan, attribute 12.5 percent of the decade long growth in residential property values for properties lying outside the city and in the metropolitan area or county by the property values a decade prior. For example, to determine the

²⁴ Shiller provides data on home prices at <http://irrationalexuberance.com/main.html?src=%2F> that he has used for figures in his book, Shiller, Robert. 2015. *Irrational Exuberance*. Princeton University Press. The data reveal that nominal home prices grew at an annual rate of 3.6 percent between 1992 and 2017 and real home prices grew at 1.3 percent per year during that same period. At a 3.6 annual growth rate, housing prices would increase 43 percent over a decade. The presence of a research university in the city would increase suburban housing price by 5.4 percent over a decade or account for 12.5 percent of the growth in housing prices in the suburbs.

²⁵ Tax valorization is discussed in detail in Bird, Richard M. and William G. Rhoads. 1969. "The Valorization Tax in Colombia: An Example for Other Developing Countries?" in A.P. Becker, ed., *Land and Building Taxes* (Madison: University of Wisconsin Press): 201-37.

valorization market value base in 2015 using our stylized example of 2 percent annual growth in property values in Onondaga County, multiply 2.75 percent by the year 2005 residential property value lying outside of Syracuse City and in Onondaga County. The city tax rate applied to that property value would be attributed to the City and add 14.2 percent to the city property value tax base using 2015 property values in the city and its suburbs lying inside of Onondaga country.²⁶ The above is a form of tax base sharing with Syracuse City. Haughwout and Inman's finding that concentrations of poverty and fiscal weakness in central cities reduce agglomeration and economic growth lends more evidence that suburban residents would have better economic prospects if they or others made the city fiscally stronger.

Property Tax Exemptions

The fact that major employers inside the city occupy tax-exempt properties creates another rationale for non-residents of the city to contribute to city finances. A recent New York State Comptroller's report notes that 56 percent of property value in Syracuse City is tax exempt and payments in lieu of taxes (PILOTs) are small in relation to the potential tax revenues if the properties were on the City's tax rolls.²⁷ The City of Syracuse in recent budget reports lists the percentage of tax-

²⁶ To arrive at the 14.2 percent figure, the 2015 taxable market value of residential property in the towns and villages of Onondaga County of \$13,830,429,727 is deflated to 2005 values assuming 2 percent annual growth in residential property values between 2005 and 2015. Taking 2.75 percent of towns and villages residential value amounts to 14.2 percent to Syracuse City's taxable market value of residential property (\$2,198,726,901) and the ability to tax that base at City tax rates would add 14.2 percent to the City's property tax revenues. Note that these figures do not include property values in Madison and Oswego counties.

²⁷ Office of the New York State Comptroller, Division of Local Government and School Accountability. "Property Tax Exemptions in New York State." *Research Brief*. October 2013.

exempt property as high as 57 percent.²⁸ The tax-exempt properties include non-profit educational institutions as well as New York State entities; and new business development in the city that often receive property tax abatements or exemptions for various time periods. The amount of tax-exempt property implies that Syracuse City residents who own taxable properties have higher tax burdens for public goods.

PILOTS - payments in lieu of taxes - are common in cities.²⁹ A recent study assesses whether PILOTS compensate cities in Massachusetts for lost revenues that result from tax exemptions.³⁰ There are at least three variables to take into account in a conceptual model of how much and who should reimburse a city for revenues forgone on its tax-exempt properties and therefore the adequacy of PILOTS. First, non-profits and for-profit firms with tax exemptions make cases that the property tax revenue forgone is as low as zero, given that the exempt organization or company might have located elsewhere in the absence of the exemption and no other development of the property would occur. Therefore, local governments forgo no property tax revenue.

A more formal economic term for this phenomenon is “crowd out”, which conveys the extent to which a particular tax-exempt property would have gone undeveloped or attracted a property of lesser value than the current tax-exempt property value. For example, if the property would have gone undeveloped, then crowd out is zero; that is, the tax exempt property does not displace another tax paying entity and the City forgoes no tax revenue. On the other hand, if the site on which the non-profit

²⁸ City of Syracuse, Annual Budget Fiscal Year Ending June 30, 2017 (Fiscal Year 2016-17) Mayor Stephanie A. Miner. http://www.syracuse.ny.us/Documents_and_Forms.aspx#Budget or http://www.syracuse.ny.us/uploadedFiles/A_Content/2016-2017%20BUDGET.pdf

²⁹ Kenyon, Daphne A and Adam H. Langley. “The Property Tax Exemption for Nonprofits and Revenue Implications for Cities.” The Lincoln Institute for Land Policy. November 2017. 10 pages.

³⁰ Fei, Fan, James R. Hines, and Jill R. Horwitz. “Are PILOTS Property Taxes for Non Profits?” *Journal of Urban Economics*. 94 (2016): 109-123.

locates would have attracted another taxpaying entity of equal value then crowd out is one. The actual crowd out figure is likely between these two values.

The presence of the non-profit activity may attract other for profit and property tax paying entities to the city or town and that would also reduce property tax crowd out. Third, the non-profit itself may provide local services that the city or town would otherwise have to provide - after school activities for grade school children, housing services or food services, for example, reducing crowd out. Several findings of the study stand out. In Massachusetts, PILOTs replace on average 8 percent of the property tax due on tax-exempt properties (Table 1). The PILOT reimbursement rates are higher in towns that have higher property tax rates; or a one-percentage higher property tax rate point increases the PILOT payment by 0.235 of a percentage point. Third, higher PILOT reimbursement rates are associated with fewer fixed assets - less land and buildings - for non-profits. The implication is that municipalities can encourage (or discourage) expansion of non-profits by maintaining a low (or high) PILOT.³¹ Whether the municipality finds expansion of non-profits attractive may depend on the aforementioned economic development implications of the nonprofit expansion. Non-profits that attract taxpaying entities to the same local jurisdiction may pay lower PILOTs to encourage their expansion.

Although the crowd out figure is not known, Boston has implemented a new PILOT program starting in 2011. New non-profits with large assets will pay 25 percent of the property tax due on their properties with a PILOT credit of up to 50 percent of the PILOT if the non-profit provides community benefits. The implied base line crowd out figure is 25 percent.³²

³¹ Ibid.

³² Ibid. page 110. See also Tom Krauss, "Mayor Miner talks nonprofit Syracuse University into making payments for city services."
http://www.syracuse.com/news/index.ssf/2011/06/mayor_stephanie_miner_talks_no.html

Syracuse City and its school district have annual property tax revenues of \$99.3 million collected on \$3.663 billion of taxable property market value. The latter figure represents 43 percent of total market value or 57 percent of Syracuse City's property value is tax exempt. Taxes due on the full value of tax-exempt property would be \$131.6 million.³³ Using the 25 percent figure for Boston as crowd out, PILOT payments would amount annually to \$32.6 million. Using the Massachusetts' average figure for PILOT payments of 8 percent, PILOT payments to Syracuse City would amount to \$10.5 million annually. The city receives \$6.8 million in PILOTs as well as has agreements to provide community services in lieu of taxes from two hospitals. The gap between revenues forgone and PILOTs received using the 8 percent replacement rate is as high as \$3.7 million or a 3.7 percent increase in City and school district property tax revenues.

Options for Syracuse Region

The Report makes a number of observations and recommendations. Instituting tax base sharing in the region for new commercial and industrial properties, combining the city and county governments, and expenditure savings through shared services among counties and cities, towns and villages represent the major recommendations. The above recommendations have merit and with appropriate qualifications have grounding in the urban public economics literature reviewed above. In fact, though, the literature provides a basis for going further than The Report's recommendations.

Consider the limitation of the major recommendations. Tax base sharing of new commercial and industrial property values mitigates beggar-thy-neighbor tax competition among local jurisdictions for businesses within the region, and it reduces the incentives to grant tax exemptions to new businesses,

³³ Divide the tax collected by .43 to arrive at the total tax due on total (exempt and non-exempt) market value of property in Syracuse City. Subtract the amount of revenue from non-exempt property to arrive at \$1331.6 million due on the value of exempt property.

according to a recent Minnesota report.³⁴ Nonetheless, tax base sharing of new commercial and industrial property values does not necessarily funnel funds to fiscal units with low tax capacity. A formula for tax base sharing that favors cities with larger populations and more poverty would both mitigate the intraregional competition for businesses and channel funds to needier populations. The Minnesota formula for sharing assures that each municipality receives a share of revenues. It can encourage small suburban units of government rather than foster consolidation of these units.³⁵

The Minneapolis area sharing of new commercial and industrial tax bases has been in place since 1971, and has taken time to build a significant source of municipal revenue for municipalities to share. A similar approach for the Syracuse region would take some time to build significant revenues to share. It may help coordinate economic development in the region, but does not promise to offer significant budget relief to Syracuse City.

City-county mergers and city annexations in general have a long history and offer a means for a city to benefit from the tax bases in its suburbs. The most recent city-county merger for Louisville-Jefferson County reveals that suburban residents have little taste for providing relief to Louisville city's finances, except through cost savings. Most of the city-county mergers have produced long-run financial gains for cities, but they also reduce local autonomy in suburban jurisdictions and for that reason as well as suburban residents' fear of tax increases to pay for services consumed elsewhere, they remain unpopular with suburban voters. Indeed, The Report carefully notes that a merger of Syracuse City and

³⁴ <https://www.minnpost.com/cityscape/2012/02/tax-base-sharing-law-gets-closer-look-twin-cities>

³⁵ In Minnesota, tax base sharing, in effect since 1971, shares about 40 percent of the commercial and industrial tax base and narrows considerably (from 10 to 1 in the absence of tax base sharing to 3 to 1 with tax base sharing) the ratio among municipalities of tax revenue received from commercial and industrial tax base. However, the program is not without controversy and calculations of winners and losers within the region. <https://www.minnpost.com/cityscape/2012/02/tax-base-sharing-law-gets-closer-look-twin-cities>

Onondaga County would leave the City with responsibilities for its outstanding debt and likewise that of Syracuse City's school district, as well as responsibility for post-employment benefit obligations for their respective employees and retirees. These are areas of major fiscal responsibility and challenges.

Cities that have thrived have annexed unincorporated suburban areas, an option unavailable to Northeastern and Midwestern cities whose suburbs are largely incorporated municipalities. Annexation gives cities access to expanded tax bases with proportionately less service obligations in these annexed areas.

The change in the U.S. economy to service-oriented jobs; the legacy of white flight, especially in many Northeastern and Midwestern central cities; and the inability to expand their tax bases have left many central cities with few fiscal options. At the same time, central cities provide valuable employment opportunities for their region's residents and through agglomeration raise productivity in their regions. The productivity effects redound to higher growth of housing prices and higher incomes for suburban residents.

The case for suburban residents shouldering responsibility for cities' finances starts with the inherent productivity and income gains that cities afford residents of their metropolitan areas. The income gains in an increasingly winner-take-all economic structure accrue to upper-income households who in large part live outside the central cities.³⁶ There is also evidence that federal policies related to access to FHA loans and other banking practices as well as white households concerns about changing neighborhoods have abetted white flight to the suburbs, leaving behind lower-income households in cities. Bloustan and others confirm the results that Wheaton found for San Francisco; namely, that

³⁶ Richard Florida makes the same argument in his book, Florida, Richard. 2017. *The New Urban Crisis*. New York: Basic Books. 310 pages. For a summary, see Florida, Richard. 2017 "The Unaffordable Urban Paradise." *MIT Technology Review: The Business Issue*. July/August: 88-91.

income alone does not explain the demand for better housing in the suburbs. She finds a widening gap between housing prices in the suburbs and their respective central cities.³⁷

Based on the above review, there is a strong case for sharing a portion of the residential suburban property tax base with the City in addition to sharing taxes on new commercial and industrial property values. Evidence suggests that leaving central cities to fend for themselves leads to lower economic growth for the region as a whole. Shared services models help to make local government more efficient, shared services by themselves will be enough to resolve the ongoing revenue shortfalls in the City.

Metropolitan government can stabilize central city finances. At the same time, metropolitan government or merged city/county government would need to emphasize the primacy of the city as an engine of economic growth in the region. Whether through city/county merger or having suburban residents contribute to the fiscal success of the City, the alternative of isolating the City and having it shoulder a fiscal burden that it can ill afford will have major negative fiscal and economic development consequences for the region overall.

³⁷ Bloustan, Leah Platt. 2017. *Competition in the Promised Land*. Princeton, NJ: Princeton University Press: Chapter 5. Bloustan compares identical housing stocks in adjacent towns - in racially diverse central cities with others in homogenous white neighborhoods. She finds housing prices are higher in more homogenous white areas that also have lower taxes and less spending on local public goods other than education. These patterns are not based solely on race, as low-income whites appear to be excluded from the homogenous suburbs as well.

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