

## Contemporary Fiscal Challenges and Positions of US Cities

Yonghong Wu (University of Illinois at Chicago)

Shu Wang (Michigan State University)

Michael A. Pagano (University of Illinois at Chicago)

### 1. Introduction

The Great Recession, by any measure, had a damaging impact on the nation and its cities. The national economy contracted, as did the economies of states, cities and metropolitan regions; the fiscal position of the nation declined, as it did for states and municipalities. Real Gross Domestic Product fell by nearly 6% between 2007 (\$14.99 trillion, 4th quarter of 2007) and 2009 (\$14.35 trillion, 2<sup>nd</sup> quarter of 2009), which was the trough of the recession.<sup>1</sup> The losses were recovered by the third quarter of 2011 (rebounding to \$15.02 trillion). Federal government revenues, primarily composed of income tax receipts, also declined but by even more, falling 21% between 2007 and 2009 (\$2.66 trillion to \$2.1 trillion, constant dollars), then rebounding to its pre-recessionary level in 2013 (\$2.77 trillion). States also witnessed a decline of over 15% in their general fund revenues between 2008 and 2010, rebounding to the pre-recessionary levels in 2013.<sup>2</sup> Municipalities, after a decline of some 12% in general fund revenues between 2006 and 2012, have yet to experience the return of their fiscal position to pre-recessionary levels.<sup>3</sup> The fiscal position of the federal government and the states appears to have been more resilient and robust than cities' fiscal position. What explains the less-than-resilient fiscal position of cities? This paper explores the many constraints on city fiscal behavior, including most notably cities' legal position as creatures of their respective states, and the wide variation in city fiscal positions as a consequence of the nesting of cities within a federal political system.

This paper examines the contemporary fiscal position of municipalities and challenges they are facing. The paper is divided into four parts. The next section presents a descriptive overview of city fiscal conditions and examines the changes in the revenue composition of cities' general funds since the Great Recession. In Section 2, we investigate the intergovernmental factors at the state level including local TELs, state aid to municipalities and tax authority, and how state-level intergovernmental factors constrain city fiscal behavior. Section 3 explores the impact of federal policy on city fiscal behavior with a focus on the effects of the Tax Cuts and Jobs Act of 2017 that places a \$10,000 cap on individual filer's deduction for state and local taxes (SALT). Even

---

<sup>1</sup> Data from the Federal Reserve Bank of St. Louis at <https://fred.stlouisfed.org/series/GDPC1>

<sup>2</sup> National Association of State Budget Officers, *Fiscal Survey of the States, Spring 2018* at: [https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/NASBO\\_Spring\\_2018\\_Fiscal\\_Survey\\_of\\_States-S.pdf](https://higherlogicdownload.s3.amazonaws.com/NASBO/9d2d2db1-c943-4f1b-b750-0fca152d64c2/UploadedImages/Fiscal%20Survey/NASBO_Spring_2018_Fiscal_Survey_of_States-S.pdf)

<sup>3</sup> Christy McFarland and Michael A. Pagano, *City Fiscal Conditions in 2017* (Washington, DC: National League of Cities, 2017) at: <http://nlc.org/sites/default/files/2017-09/NLC%20City%20Fiscal%20Conditions%202017.pdf>

though federal aid to cities is relatively small, the long-standing deductibility of SALT affects voter behavior, thereby affecting the demand and cost of municipal service delivery. Now that SALT has been capped, will voting behavior change and have a dampening effect on the ‘size’ of service delivery? Finally, we conclude the paper with a brief assessment of the future of cities’ fiscal positions.

## 2. The Contemporary Fiscal Position of US Cities

The national economic picture, which is painted in broad strokes as if all sectors have been growing and improving since the end of the Great Recession, is not always reflected in municipal coffers. One example can be found in the dynamic growth of consumer sales since the end of the Great Recession. Although retail sales surged after 2009 (the official end of the recession), the growth rate of retail sales tax collections however was lower due in large part to the fact that internet sales were in most cases not collected. This meant that state and local governments collected less retail sales tax revenue as a consequence of internet sales than they would have had if those sales had been made in a brick-and-mortar store.

That issue, referred in many cases as prejudicial to Main Street merchants, was addressed by the Supreme Court at the end of its 2018 session.<sup>4</sup> No longer does ‘physical presence’ in a material way need to be demonstrated, now that an electronic presence of most sellers is ubiquitous. Moreover, the Court ruled that a tax on internet sales would not jeopardize interstate commerce. The seller is now required to collect and remit appropriate sales taxes. The impact on sales tax collections nationwide could be substantial. In the Opinion of the Court, the majority cited the magnitude of the loss by noting:

In 1992, it was estimated that the States were losing between \$694 million and \$3 billion per year in sales tax revenues as a result of the physical presence rule. New estimates range from \$8 to \$33 billion ... The South Dakota Legislature has declared an emergency, S. B. 106, §9, which again demonstrates urgency of overturning the physical presence rule. The argument, moreover, that the physical presence rule is clear and easy to apply is unsound.<sup>5</sup>

Most states’ coffers will benefit from the new ruling since 45 states impose a retail sales tax, but only slightly more than half of the nation’s municipalities will benefit. Those cities with a local option sales tax connect the purchase or consumption of goods (and depending on the city, some services), which certainly is part of the ‘gross metropolitan product’ of the city, to the city’s fiscal architecture. As consumption increases, sales tax collections increase; and vice versa. The Court’s ruling, then, may affect the fiscal position of a majority of cities, but many cities will not feel the court’s impact. Boston, for example, generated retail sales of approximately \$11,500 per capita in 2010, yet because it is not permitted to adopt a local option sales tax, it collected

---

<sup>4</sup> *South Dakota v. Wayfair, Inc., et al.*, No. 17-494 (Decided June 21, 2018).

<sup>5</sup> *Ibid.*, p. 19.

nothing. Denver also generated approximately the same amount of retail sales on a per capita basis, but contributed nearly 20% of Denver’s total revenues in 2010 because it does have the authority to tax retail sales.

These illustrations demonstrate a wider truth about municipal finance in the US, namely, changes to a city’s underlying economy are not always reflected in the city’s revenue collections. In other words, if retail sales increase and a city is not authorized to levy a sales tax, it hardly matters. What does matter is a city’s alignment of its taxing authority with the major drivers of its underlying economy.

A city’s taxing (and fee) authority can include general taxes, such as a tax on retail sales, income or wages, and the ubiquitous property tax. Yet, there are many others as well, including utility taxes, telecommunications taxes, water and sewer fees, building inspection fees, and property tax transactions. These are referred to as own-source revenues, which are the fees and charges over which a municipality has control. As Table 1 indicates, the composition of cities’ own-source revenues indicates that the category “Charges and Misc. Revenue” has generated more revenue than the ubiquitous property tax since the early 1980s. Charges and fees now amount to approximately two of every five dollars collected by municipalities, while property taxes have generated slightly less than one-third of own-source revenues. This shift in prominence from property tax domination to charges/fees is not likely to reverse itself. Indeed, user fees and charges will probably continue to grow in stature over time.<sup>6</sup>

**Table 1: Own-Source Revenue**

Revenue Source	1977	1982	1987	1992	1997	2002	2007	2012
Property Taxes	42.70%	32.73%	32.73%	29.40%	28.85%	29.09%	29.72%	32.41%
Sales and Gross Receipts Taxes	15.84%	17.06%	17.06%	16.88%	17.10%	17.72%	16.92%	17.50%
Income Taxes	8.47%	8.34%	8.34%	8.69%	8.61%	7.56%	8.77%	8.21%
Other Taxes	4.16%	4.04%	4.04%	4.95%	4.68%	5.74%	6.18%	4.55%
Charges and Misc. Revenue	28.83%	37.84%	37.84%	40.09%	40.76%	40.13%	38.41%	37.33%

Source: Census Bureau, Government Finances

A closer examination of the General Fund (exclusive of all other funds, such as the capital improvement funds, enterprise funds, special revenue funds)--which is the largest fund of municipal governments, accounting for approximately 55% of total municipal funds, and the

<sup>6</sup> See e.g., John R. Bartle, Kenneth A. Kriz and Boris Morozov, “Local Government Revenue Structure: Trends and Challenges,” *Journal of Public Budgeting, Accounting, and Financial Management* 23:2 (2011): 268 – 287; Michael A. Pagano, “Creative Designs of the Patchwork Quilt of Municipal Finance,” in Gregory K. Ingram and Yu-Hung Hong, *The Changing Landscape of Local Public Revenues* (Cambridge, MA: Lincoln Institute of Land Policy, 2010), pp. 116-140.

fund over which city councils have the most discretion--reveals a troubling feature. According to the most recent data available on municipal general funds, cities' revenues to the general fund have yet to return to their pre-recessionary levels in constant dollars. In other words, the fund that typically provides financial support for cities' general operations, including police and fire services, have not rebounded to the pre-2007 levels (as of 2018), whereas the federal government's resources returned to pre-recessionary levels in 2013.

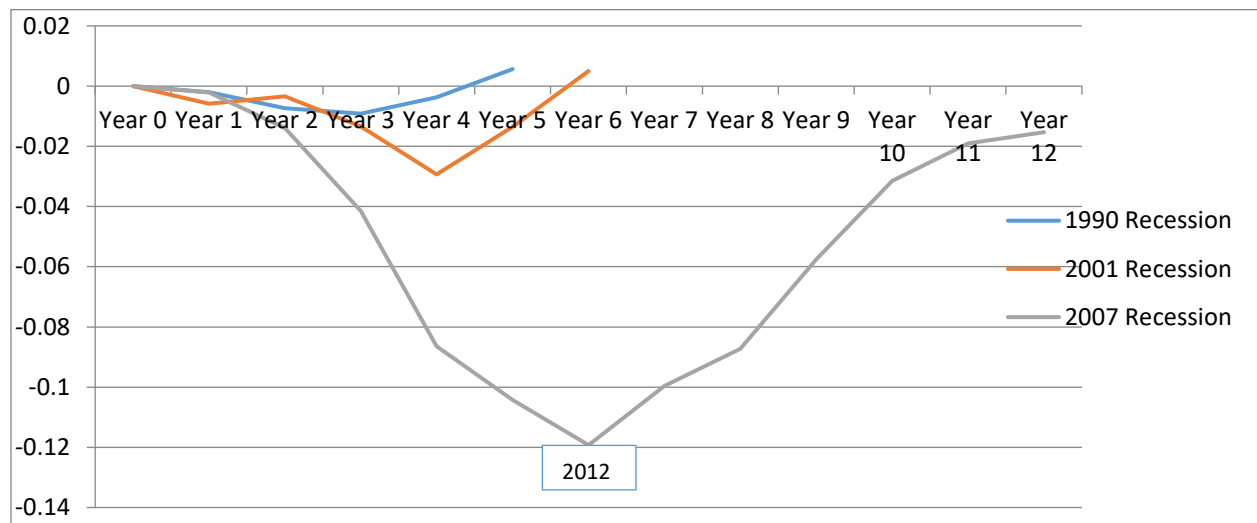


Figure 1: Comparative General Fund Revenue Recovery over 3 Recessions

Source: Data collected from National League of Cities annual survey of “city fiscal conditions”, including data for FY2018. An earlier version, including data through FY17 was published in Christiana McFarland and Michael A. Pagano, *City Fiscal Conditions in 2017* (Washington, DC: National League of Cities, 2017)

Property taxes, which are collected on the assessed value of land and structures, have been improving over the last few years, but it is questionable whether or not the future growth in property values will approach the pre-hyper growth era of the late 1990s. If that forecast holds, growth in real estate taxes will most likely be modest. Additional increases to the tax rate might grow municipal revenues in the future. In that same vein, however, increasing the tax rates on sales or income could also grow revenues for those cities with such an authority. Should it prove difficult politically (or legally) to raise tax rates, cities will continue to find services and activities to which a fee can be applied.

### 3. Cities in the Intergovernmental Context

Cities operate within an institutional framework laid out by state governments. The framework enables cities to make fiscal decisions while imposes constraints on their behaviors at the same

time, shaping the fiscal policy space of cities (Pagano et al. 2016; Pagano and Hoene, 2018). In this section we discuss key intergovernmental attributes that affect city fiscal behavior. Specifically, we examine the two dimensions of local autonomy identified by Wolman, McManmon, Bell, and Brunori (2008): capacity and discretion, and how they are shaped by the institutional design of the state.

First, for city fiscal capacity, *taxing authority* granted by the state greatly affects cities' ability to extract revenues from their economic base, and the stability of revenue structure. Scholarship has often appraised revenue diversification as a tool to enhance revenue stability that enhances governments' resilience to the shocks in external economic environment (Carroll 2009; Wolman et al. 2008). However, the degree of diversification is dictated by the number of tax sources authorized by the state. To examine the variation of taxing authority in the US, Hoene and McFarland (2015) rate municipalities based on whether they have the authority to levy property taxes, sales taxes, or income taxes, whether they can set the tax rate, and if the revenues are for general use (opposed to earmarked for specific use). The rating shows a wide variation across states in terms of fiscal authority. Pagano et al. (2016) examine main tax sources (property taxes, sales taxes, and income tax) among 100 largest cities<sup>7</sup>, and find that the most common state fiscal structure is one in which a state allows its cities to levy two local option taxes. Most cities are granted the authority to impose a tax on real estate, a ubiquitous tax for municipal governments. More than 55 percent of all municipalities are granted the authority to levy a tax on retail sales, and approximately 11 percent can tax income or earnings.

How taxing authority is structured and administered at the local level adds complexity to the issue. Take income tax for example; among the three major taxes, an incomes tax is used the least and, where authorized, they vary in application and structure. In the state of Michigan, cities do not levy sales tax but have authority to levy income taxes. However, the income tax will have to be placed on ballot and approved by local voters. Due to the administrative burden and possible political obstacles, only 18 out of 276 cities in Michigan have income tax as a tax source. In contrast, the local income tax is levied by nearly all municipalities in Ohio and Pennsylvania; in Ohio and Kentucky, the earnings tax is imposed on net business income and on wages earned at both the place of employment and the place of residence, meaning that it is also a commuter tax. How income as the tax base is defined also differs by state. Ohio and Kentucky cities can tax business profits at the same rate as individual income. Cities in Washington State can levy a business and occupancy (B&O) tax on all businesses, including ones that sell services, as well as on incomes derived from working within the city boundary.

*State aid.* Aid to cities provided by the states also affects the capacity cities have for service provision. How states distribute their funds to cities vary widely from state to state. States can

---

<sup>7</sup> The 100 cities are economically representative of the municipal sector using a selection method that crudely approximate the relative economic and fiscal importance of large cities within metropolitan areas. To be included in the sample, a city must be among the largest US central cities and be within the largest metropolitan statistical areas in the US.

provide discretionary funding or provide assistance through project- or need-based grants. Earmarking is another tool of state aid distribution; to cities through earmarking, that is, designating some or all of a specific tax for a specific expenditure. States earmark different types of taxes for local governments' uses, including general and selective sales taxes, utilities taxes, personal or corporation income taxes, and severance taxes (Purez 2008). Local governments other than school districts are the beneficiaries of earmarked state taxes in 46 states; the taxes most commonly earmarked are motor fuel taxes (22 states) and general sales taxes (17 states), and the most common expenditure is local roads and highways.

In theory, earmarking is a useful tool to enhance fiscal accountability because it allows voters to designate taxes to finance specific public services (Buchanan 1963). It also secures a revenue stream for functional responsibilities shouldered by local governments. In practice, how earmarked revenue affects local spending is more complicated. Earmarked funds can be fungible in that they can be used as a substitute for other sources of revenue (Deran 1965; Dye and McGuire 1992), and the impacts of the earmarked dollar on expenditures would be the same as general fund dollars. Earmarking can also provide cities with more flexibility. By providing a new line of funding for existing programs, it frees up monies in the general fund that can now be used for other purposes. In this case, there will be increase in spending in the programs that are not funded by the earmarked taxes (Oakland 1985; Hendrick and Wang 2018). Alternatively, earmarking can draw more resources to the program that the earmarked dollars are designated for, leading to more spending for the earmarked program (Afonso 2015). In this case, the spending for the earmarked program will increase while the spending for non-earmarked programs decreases. Unfortunately, there is no comprehensive survey of how assistance to cities is structured in each state. Future research is needed to first understand common ways of state aid distribution and then assess their efficiency and equity.

To indicate fiscal capacity of cities, we examine the change of revenue reliance by source of 150 largest cities in the US from 1977 to 2015. (For a detailed description of the sample, see Langley 2016). It is important to first point out that there is variation of taxing authority in this sample. Although all cities have authority to levy property taxes, 14 cities do not have revenue generated from sales tax, and only 25 cities have authority to levy individual income tax and exercised such authority. As an important aspect of fiscal capacity, taxing authority lays down the foundation for cities' revenue structure.

Revenue reliance is measured by the percentage of a revenue source in city general revenue. We calculated the average revenue reliance by source across cities of each year. As shown in figure 2, property taxes remain the main revenue source for cities throughout this time. State aid is also an important part for cities' revenue structure and makes up around 15 percent of the general revenue. The change of state aid has remained stagnant after 2007 with a sign of decline. In contrast, the reliance on sales taxes has increased steadily overtime from 10 percent to 15 percent. In fact, the number of cities in the sample that exercise sales tax authority has also

grown from 20 in 1977 to 25 in 2015. The trend suggests that cities are seeking more diversified revenue structure, but it would only be possible when states enable them to do so.

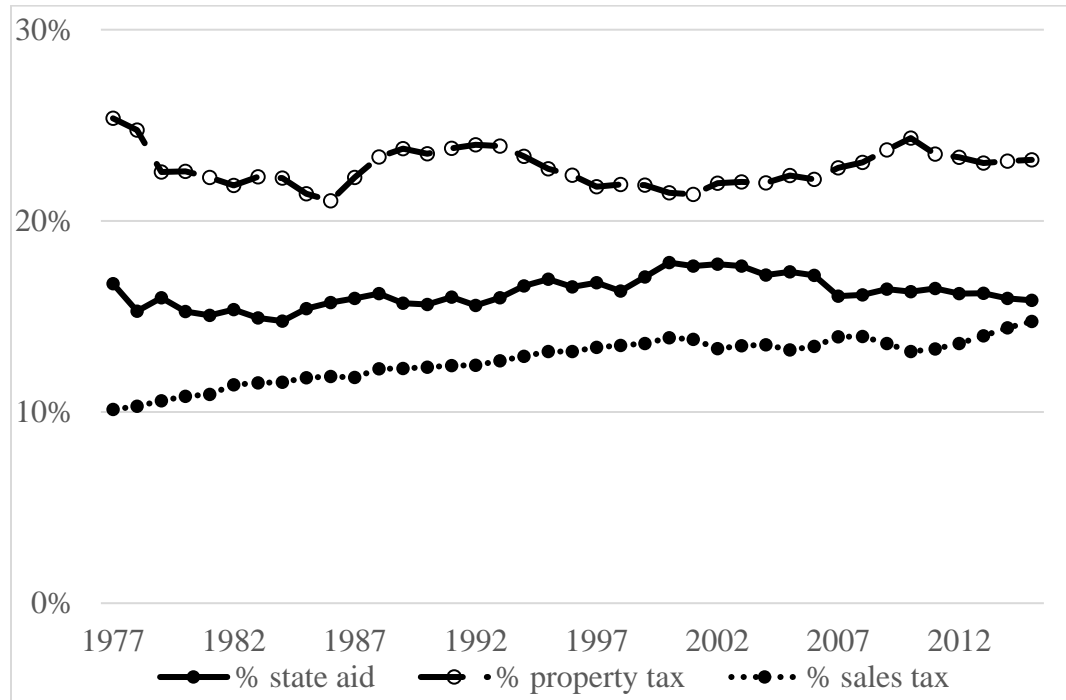


Figure 2: City Revenue Reliance by Source from 1977 to 2015  
 Source: US Census of Governments. <http://datatoolkits.lincolinst.edu/subcenters/fiscally-standardized-cities/>.  
 Accessed on: June 08, 2018

Second, various state fiscal policies constrain cities fiscal discretion. Here we discuss home rule, and tax and expenditure limits, as additional key policies that lay out the architecture of the institutional framework within which cities operate.

*Home rule.* Since the United States Constitution does not suggest what type of authority local governments should possess nor are local governments mentioned at all, the Tenth Amendment reserves authority-giving powers to the states or to the people. Dillon’s Rule and home rule are usually used as crude proxies for local government authority enabled by the state. In the case of *City of Clinton v. Cedar Rapids and Missouri River Railroad* (1868), Judge Dillon summarized his view of the relationship between the state government and local governments that “Municipal corporations owe their origin to, and derive their powers and rights wholly from, the legislature.” Dillon’s rule allows a state legislature to control local government affairs such as government structure, methods of financing service provisions, and the authority of enacting local-level policies. Related to the separation of powers, Dillon’s Rule refers to a tool used by courts to construe grants of local government autonomy. Since the court becomes involved only when a case is brought before them, it exercises little control over local government autonomy and when

it does, it operates in reactive fashion and interprets grants of authority from the state legislature (Richardson 2011).

In contrast, home rule refers to a state constitutional provision or legislative action that provides a local government with self-governance ability (Black 1990). The local authority is usually granted through local charters and state statutes, both of which are initiated by the state legislature. Unlike Dillon's Rule that is a standard of statutory construction, that is, a court must not impose its own interpretation on a statute but should defer to the legislature to ascertain the legislative intent (Richardson 2011), the power granted under home rule is usually limited to specific fields and subject to judicial interpretation. Theorists have made efforts to classify types of home rule in various ways, including by the way authority operates (Welch 1999), by the structure of the local authority (Mead 1997; Krane, Rigos and Hill 2001), or by the source of the authority (Welch 1999). Regardless the classification, no type of home rule equates to total local freedom from state oversight (Richardson, Gough and Puentes 2003). There is also a wide variation across states in terms of the policy area over which local governments have discretion. Krane et al. (2001) documents how states define home rule differently and grant local governments different degrees of autonomy for different fields, such as functional responsibilities, administrative discretion, economic development, and revenue-raising power. Even when local governments are granted with the home rule authority, in many states local policies are only valid when they are not contradictory to state statutes.

*Tax and expenditure limits.* Although property taxes are a major revenue source for most cities in the US, states can impose limits on the level of property tax levied by local governments. The limits, also known as tax and expenditure limits (TEs), can be caps on millage rates, assessment growth, property tax levy growth, or combinations of these caps (Mullins and Wallin 2004). By 2015, 29 states impose levy limits, 32 states impose rate limits, and 15 states impose limits on assessed value growth<sup>8</sup> (Lincoln Institute of Land Policy 2015). Five states (Arizona, California, Colorado, Nebraska, and New Jersey) also impose limits on local revenue and spending growth. Figure 3 shows the types of TEs imposed by different states.

The limits vary by maximum allowable rate for growth; for example, Washington sets a ten-mill limit for local governments, whereas the rate limit in Pennsylvania is set at 12 mill. This ceiling rate can also vary within one state by class of cities or by type of government. The administration of limits also differs from state to state. Massachusetts imposes a cap on municipal property tax levy at 2.5 percent. Texas administers its levy limit through a rollback rate; that is, levy increases are limited to the lesser of the rate to generate the same revenue as the prior year, which is called the effective rate, or the rollback rate. By constraining the accessibility of local governments to their economic base, TEs disconnect a city's growth in tax revenue from its economic growth.

---

<sup>8</sup> Significant Features of the Property Tax. <http://datatoolkits.lincolninst.edu/subcenters/significant-features-property-tax/state-by-state-property-tax-in-detail>. Lincoln Institute of Land Policy and George Washington Institute of Public Policy. (State-by-State Property Tax in Detail; accessed: 5/30/2018 4:01:53 PM)





In America's federal system, state-local fiscal relationship is much more substantive and complex than what relates federal government and state-local governments. States are not created by the federal government and the power to govern is constitutionally divided between the two levels of government. Since the growth in federal government financial assistance was challenged in the 1970s and 1980s, the direct federal aid to state and local governments has been shrinking. Meanwhile, the Congress and President decentralized (and 'devolved') more program responsibilities to states and localities. As a result, state and local governments play a primary role in domestic policy arenas.

Although direct federal aid has been declining in significance to local government finances, the federal government has continued subsidizing state and local governments in other indirect ways. For example, the interest income received by investors in state and local government bonds is not taxed by either federal individual or corporate income taxes. The federal tax exemption of state and local bond interest started when the federal income tax became constitutional in 1913. The exemption allows state and local governments to issue bonds at lower than market interest rates and therefore subsidizes state and local borrowing, particularly capital investments. Although the uses of tax-exempt debt by state and local governments have been restricted over the years particularly in the Tax Reform Act of 1986, this form of federal subsidy has remained and even survived the most recent reform of federal tax system under the Trump Administration.

Also dating from the first federal Income Tax Act of 1913, another indirect federal subsidy through the federal income tax system is to allow deductions for certain taxes paid to state and local governments. In itemizing deductions for federal income tax, taxpayers are allowed to include deductions for state and local property taxes, general sales and income taxes. By reducing the federal income tax base, a portion of state and local taxes is offset by a lower federal income tax liability. For example, if one federal income tax filer paid \$20,000 property and general sales taxes and her marginal federal income tax rate is 28%, she can reduce her federal income tax by \$5,600.

The Tax Cuts and Jobs Act of 2017 places a \$10,000 cap on deduction for certain state and local taxes<sup>9</sup>. The Section 11042 is quoted below:

“This section temporarily limits individual deductions for certain state and local taxes to \$10,000 per year (\$5,000 for a married taxpayer filing a separate return). The limit does not apply to taxes paid or accrued in carrying on a trade or business or for expenses for the production of income.”<sup>10</sup>

---

<sup>9</sup> This represents state and local property tax, general sales and income tax that are deductible from federal income taxation.

<sup>10</sup> Accessed on May 25, 2018 from <https://www.congress.gov/bill/115th-congress/house-bill/1>.

The law still allows filers of federal income tax returns who choose itemized deduction to subtract state and local property tax and income tax or general sales tax from their federal taxable income within the limit. While the provision will reduce federal tax expenditures, it will affect almost all state and local governments as some taxpayers will have to claim smaller amounts of taxes they pay to state and local governments. As a result, their federal income taxes will rise and after-tax incomes will shrink.

Given the substantial variation in the percentage of filers who claim the SALT deduction and the amounts of the deduction, the impact of this cap is likely to vary across states, especially because the standard deduction increases under the new tax law, resulting in fewer filers who itemize deductions. Much of the attention has concentrated on a handful of large and rich states such as California and New York. Other states will also feel the influence as well. The passage of the tax bill has received a great deal of attention from scholars and practitioners regarding how much it will affect state and local government finances. Some well-known think-tank organizations such as the Pew Charitable Trusts have come up with some initial estimates about the potential impact of this provision. According to a recent analysis from the Pew Charitable Trusts, the impact of the cap on SALT deduction could be far-reaching because federal income tax filers in 19 states who took the SALT deduction claimed more on average than the cap allows in 2015, the latest year with available data.

The SALT cap provision will increase federal income tax liability for certain federal income tax filers because they are not allowed to claim SALT deduction beyond the limit. It will affect state and local finances because the after-tax incomes of certain taxpayers will be lower than without the cap. Using a data set from the Internal Revenue Service (IRS), we estimate how many taxpayers are affected, and the extent to which they will be affected. We also explore how the cap on SALT deduction will affect state and local government revenues and expenditures. We provide preliminary evidence to improve our understanding of the tax bill's impact on subnational government finances.

The source of data is the IRS Statistics of Income, Historic Table 2, "Individual Income and Tax Data, by State and Size of Adjusted Gross Income" for tax year 2015.<sup>11</sup> The data is based on administrative records of individual income tax returns (Forms 1040). Included in the data are federal income tax returns filed during the 12-month period, January 1, 2016 to December 31, 2016.<sup>12</sup>

The data are available for multiple levels of filers' adjusted gross income (AGI). We calculate the percentage of filers who choose itemized deductions, the percentage of filers with itemized deductions also claim SALT deductions, and the percentages of filers with itemized deductions claim deductions for real estate taxes, general sales taxes, or state-local income taxes. As shown

---

<sup>11</sup> The data is accessible at <https://www.irs.gov/statistics/soi-tax-stats-historic-table-2>.

<sup>12</sup> While most of the returns filed during the 12-month period are primarily for Tax Year 2015, the IRS received a limited number of returns for tax years before 2015 and these have been included within the data.

in Table 2, the three percentages move up as the AGI level increase with one exception: the percentage of filers with itemized deductions who claim general sales tax declines with higher AGIs. This makes sense because state-local income taxes tend to grow more rapidly with income than general sales tax, and taxpayers tend to include the larger of the two taxes in their deductions. Another observation is that when filers itemize their deductions most of them include SALT deduction even when their AGIs are quite low.

**Table 2: Filers with Itemized Deductions and SALT Deductions**

Level of AGI	% of filers who itemize deductions	% of filers with itemized deductions who deduct SALT	% of filers with itemized deductions who deduct state-local income taxes	% of filers with itemized deductions who deduct general sales taxes	% of filers with itemized deductions who deduct real estate taxes
\$1 ~ \$10,000	3.6	79.7	25.9	53.9	69.1
\$10,000 ~ \$25,000	7.3	87.7	39.6	48.2	67.2
\$25,000 ~ \$50,000	19.1	92.4	61.7	30.7	71.2
\$50,000 ~ \$75,000	38.4	94.7	72.7	22.0	81.3
\$75,000 ~ \$100,000	53.6	95.9	78.3	17.7	86.3
\$100,000 ~ \$200,000	76.0	97.0	82.1	14.9	90.6
\$200,000 ~ \$500,000	93.6	98.1	83.0	15.1	91.8
\$500,000 ~ \$1,000,000	93.2	99.0	84.7	14.3	93.4
\$1,000,000 or more	91.5	99.3	87.9	11.4	94.2

Source: Authors' computation

For the tax year 2015, the total number of federal income tax returns was 149,726,990, and about 30 percent of them itemized deductions. Among the 44,671,840 filers who itemized deductions, 37,538,310 claimed deductions for real estate taxes, 9,545,210 claimed deductions for general sales taxes, and 32,956,930 claim deductions for state-local income taxes. We determine that 42,502,140 filers claimed SALT deductions in 2015 – about 95 percent of all filers who chose to itemize deductions. The total deducted real estate taxes, general sales taxes, and state-local income taxes were \$374,771 million, \$16,778 million, and \$334,386 million, respectively.

We expect that the excess of SALT deductions that will not be allowed under the new cap to vary by level of AGI. We first divide the total amount of SALT deductions by the number of filers who claim deductions of SALT to calculate the average SALT deduction for each level of AGI. As shown in Table 3, the average SALT deduction per filer rises with the level of AGI. In particular, the average SALT deduction per file is below \$10,000 if the AGI is under \$100,000. We further determine that 54 percent of the filers who itemize SALT deductions will not be affected by the new cap provision. On the other hand, the remaining 46 percent of the filers who deduct SALT would not have been able to claim the same amount of SALT deduction if the cap

were imposed because their average SALT deduction is beyond \$10,000. The magnitude of the excess of SALT deductions per filer gets larger for filers with higher AGIs.

**Table 3: Excess of SALT Deductions**

Level of AGI	Number of filers who deduct SALT	Average SALT deduction per filer (in \$000s)	Excess of SALT deduction per filer (in \$000s)
\$1 ~ \$10,000	621,110	4.21	0.00
\$10,000 ~ \$25,000	2,113,330	3.54	0.00
\$25,000 ~ \$50,000	6,179,510	4.01	0.00
\$50,000 ~ \$75,000	7,253,100	5.50	0.00
\$75,000 ~ \$100,000	6,645,180	7.24	0.00
\$100,000 ~ \$200,000	13,520,160	11.08	1.08
\$200,000 ~ \$500,000	4,973,970	22.82	12.82
\$500,000 ~ \$1,000,000	797,700	54.35	44.35
\$1,000,000 or more	398,090	273.55	263.55

Source: Authors' computation

For the whole country the aggregate excess of SALT deductions is about \$219 billion. If there were the \$10,000 cap on SALT in 2015, the filers would not have been allowed to claim \$219 billion, or about 30 percent of total SALT deductions in that year.<sup>13</sup> We also estimate the total excess of SALT deductions for each state and compare the excess amount to the state's total collection of SALT. As shown in Table 4, the excess of SALT deductions as a percentage of total SALT varies substantially across states. Compared with their own SALT, the sizes of excess SALT deductions are highest for California, Connecticut, New York, New Jersey and Maryland, and lowest for Alaska, South Dakota, Tennessee, Washington and Mississippi. In other words, the states of California, Connecticut, New York, New Jersey and Maryland will be mostly affected by the SALT cap provision because over 25 percent of their SALT could not have been deducted if the cap were effective in 2015. On the other hand, some states will not be much affected. The total excess of SALT deductions is below five percent of total SALT revenues for nine states, including Alaska, South Dakota, Tennessee, Washington, Mississippi, North Dakota, Texas, New Mexico and Wyoming.

**Table 4: Excess of SALT Deductions by State**

State	Total excess of SALT deductions	Total SALT	Total excess of SALT deductions as percent of total SALT
Alabama	0.57	10.60	5.41%
Alaska	0.01	1.71	0.76%

<sup>13</sup> The total SALT deductions are \$725,935 million.

Arizona	1.47	20.10	7.31%
Arkansas	0.79	9.01	8.76%
California	62.80	185.00	34.03%
Colorado	2.22	20.50	10.82%
Connecticut	7.47	22.50	33.24%
Delaware	0.36	2.01	18.15%
District of Columbia	1.22	5.44	22.51%
Florida	4.70	48.90	9.63%
Georgia	3.76	30.40	12.38%
Hawaii	0.58	6.74	8.64%
Idaho	0.48	4.54	10.51%
Illinois	8.26	55.80	14.79%
Indiana	1.49	20.20	7.41%
Iowa	1.09	11.80	9.24%
Kansas	0.77	10.50	7.33%
Kentucky	1.28	12.10	10.56%
Louisiana	0.75	14.10	5.30%
Maine	0.60	5.55	10.89%
Maryland	6.92	27.00	25.65%
Massachusetts	8.58	35.60	24.08%
Michigan	2.89	32.20	8.97%
Minnesota	4.87	24.40	19.94%
Mississippi	0.34	8.11	4.15%
Missouri	2.07	18.10	11.43%
Montana	0.35	2.74	12.67%
Nebraska	0.78	7.99	9.75%
Nevada	0.44	7.48	5.84%
New Hampshire	0.39	4.16	9.31%
New Jersey	15.80	49.90	31.68%
New Mexico	0.29	6.23	4.60%
New York	44.30	137.00	32.25%
North Carolina	3.42	30.20	11.31%
North Dakota	0.13	3.07	4.21%
Ohio	4.56	42.70	10.67%
Oklahoma	0.89	10.70	8.29%
Oregon	3.20	13.00	24.64%
Pennsylvania	5.90	46.00	12.82%
Rhode Island	0.66	4.65	14.11%
South Carolina	1.20	13.30	8.98%
South Dakota	0.06	2.52	2.23%
Tennessee	0.46	14.80	3.08%
Texas	3.79	88.60	4.28%
Utah	0.88	8.72	10.06%
Vermont	0.39	2.68	14.67%
Virginia	5.05	29.80	16.97%
Washington	0.99	25.80	3.82%
West Virginia	0.31	4.88	6.40%
Wisconsin	3.21	21.70	14.80%
Wyoming	0.12	2.43	4.80%
United States Total	219.00	1220.00	17.87%

Source: Authors' computation

Note: The tax revenues are in billions of dollars.

The capped SALT deductions do not affect state and local tax revenues directly. Its direct impact is to reduce taxpayers' after-tax incomes. Some high-income taxpayers will face larger federal income tax liability because their allowable SALT deductions are capped at \$10,000. As discussed earlier, more than half of the filers will not be affected by this cap. According to the median voter model, the demand for state and local government services will not change because it is very likely that this provision does not change the demand of the decisive median voters. However, there is concern that high-income taxpayers will consider relocating from high-tax states to low-tax states because they are those who are affected the most. To estimate the impact on relocation of high-income taxpayers, we examine the extent to which the cap on SALT will affect personal incomes.

We follow a four-step approach to estimate the effect on the filers' income. First, the excess of SALT deductions over the cap is determined for each level of AGI. Second, we calculate a weighted average marginal tax rate for each level of AGI by multiplying the shares of different types of filers (single, married filed jointly, and head of household) and the corresponding marginal federal income tax rates in 2015. Third, we multiply the excess of SALT deductions and the weighted average marginal tax rate. This would be the reduced personal income if the cap were effective. Last, we divide the reduced personal income by the AGI. This approximates the percent reduction of personal income due to the cap provision. Table 5 presents both the estimated percent reduction of income as a result of the cap and the number of the filers who claim SALT.

**Table 5: The Impact of SALT Cap on Income**

State	Level of AGI				
	\$75,000 ~ \$100,000	\$100,000 ~ \$200,000	\$200,000 ~ \$500,000	\$500,000 ~ \$1,000,000	\$1,000,000 or more
Alabama	0.00%	0.00%	0.40%	1.19%	1.46%
Alaska	0.00%	0.00%	0.00%	0.28%	0.40%
Arizona	0.00%	0.00%	0.55%	1.60%	2.02%
Arkansas	0.00%	0.00%	1.16%	2.30%	2.19%
California	0.00%	0.50%	2.24%	3.92%	5.08%
Colorado	0.00%	0.00%	0.74%	1.72%	2.07%
Connecticut	0.00%	0.78%	2.10%	3.38%	3.50%
Delaware	0.00%	0.00%	1.23%	2.47%	2.67%
District of Columbia	0.00%	0.40%	1.91%	3.41%	3.54%
Florida	0.00%	0.00%	0.36%	1.03%	1.40%
Georgia	0.00%	0.00%	1.17%	2.12%	2.29%
Hawaii	0.00%	0.00%	1.44%	3.17%	3.77%
Idaho	0.00%	0.00%	1.39%	2.51%	2.53%
Illinois	0.00%	0.28%	1.30%	2.11%	2.15%
Indiana	0.00%	0.00%	0.87%	1.81%	2.18%
Iowa	0.00%	0.16%	1.44%	2.40%	2.31%
Kansas	0.00%	0.00%	0.82%	1.59%	1.90%
Kentucky	0.00%	0.15%	1.46%	2.50%	2.37%
Louisiana	0.00%	0.00%	0.59%	1.46%	1.47%
Maine	0.00%	0.40%	1.88%	3.16%	3.30%
Maryland	0.00%	0.64%	2.05%	3.43%	3.61%

Massachusetts	0.00%	0.43%	1.56%	2.52%	2.68%
Michigan	0.00%	0.00%	1.06%	1.94%	1.92%
Minnesota	0.00%	0.20%	1.81%	3.44%	4.02%
Mississippi	0.00%	0.00%	0.68%	1.65%	1.74%
Missouri	0.00%	0.00%	1.17%	2.23%	2.47%
Montana	0.00%	0.00%	1.33%	2.45%	2.73%
Nebraska	0.00%	0.16%	1.48%	2.59%	2.21%
Nevada	0.00%	0.00%	0.04%	0.85%	1.32%
New Hampshire	0.00%	0.00%	0.69%	1.31%	1.90%
New Jersey	0.02%	0.90%	2.26%	3.61%	4.04%
New Mexico	0.00%	0.00%	0.76%	1.62%	1.81%
New York	0.00%	1.03%	2.64%	4.20%	4.88%
North Carolina	0.00%	0.00%	1.24%	2.26%	2.26%
North Dakota	0.00%	0.00%	0.18%	1.04%	1.66%
Ohio	0.00%	0.21%	1.47%	2.47%	2.51%
Oklahoma	0.00%	0.00%	0.84%	1.75%	1.68%
Oregon	0.00%	0.65%	2.22%	3.50%	3.66%
Pennsylvania	0.00%	0.23%	1.26%	2.02%	1.86%
Rhode Island	0.00%	0.35%	1.66%	2.74%	3.10%
South Carolina	0.00%	0.00%	1.11%	2.07%	2.03%
South Dakota	0.00%	0.00%	0.05%	0.49%	0.90%
Tennessee	0.00%	0.00%	0.03%	0.50%	1.12%
Texas	0.00%	0.00%	0.44%	0.88%	0.76%
Utah	0.00%	0.00%	0.98%	1.84%	2.18%
Vermont	0.00%	0.49%	2.02%	3.43%	3.39%
Virginia	0.00%	0.12%	1.30%	2.31%	2.53%
Washington	0.00%	0.00%	0.27%	0.75%	0.80%
West Virginia	0.00%	0.00%	1.22%	2.38%	2.77%
Wisconsin	0.00%	0.39%	1.64%	2.75%	2.86%
Wyoming	0.00%	0.00%	0.00%	0.56%	1.37%
United States Total	0.00%	0.21%	1.48%	2.60%	3.15%

Source: Authors' computation

Note: Each percentage refers to the estimated reduction of income as a result of the cap as percent of AGI of the filers who claim SALT. The number underneath each percentage is the number of the filers who claim SALT.

It turns out that the cap provision will not have a large impact on personal incomes. For the country as a whole, the estimated reductions of income are 3.15%, 2.60%, 1.48%, and 0.21% of the adjusted gross income for filers with AGI at \$1 million or more, \$0.5 million to \$1 million, \$0.2 million to \$0.5 million, and \$0.1 million to \$0.2 million, respectively. Filers in all states except Alaska and Wyoming will feel the impact if their AGIs are above \$0.2 million a year. However, the magnitude of the impact is modest, between 0.03 and 5.08 percent of AGI. Those with AGI at or over \$1 million will see over four percent reduction in their incomes in four states: California (70,890 filers), New York (49,230 filers), New Jersey (19,290 filers) and Minnesota (6,910 filers). The estimated impact at the same top level of AGI is below one percent in Alaska (360 filers), Texas (26,300 filers), Washington (6,920 filers) and South Dakota (630 filers).

## 5. Conclusion



The aftermath of the Great Recession witnessed the rebounding of government revenues at federal, state and municipal levels in the US. Unlike the federal and state governments, municipal governments have not yet fully recovered from substantial revenue losses to their General Funds even ten years after the official ending of the recession. The sluggish recovery of municipal finances presents a major challenge to municipal governments. This paper explores several underlying factors that have led to the current municipal fiscal situation.

The fact that the recovery of municipal general-fund revenues does not keep pace with the rebounding economy indicates a problematic alignment of a city's economic base to its fiscal architecture. While a strong local economic base is the foundation of a city's fiscal capacity, a city's fiscal architecture is greatly shaped by state control. Through various constraints on local autonomy, states can constrain the city's fiscal capacity by setting limits on how much revenue a city can extract from its economic base. For instance, a strong retail sales sector cannot generate much tax revenue if the city does not have authority to tax retail sales or if its authority is strictly limited. Slightly less than half of all municipalities are not granted the authority to levy a tax on retail sales, and about nine in ten cannot tax income or earnings. Almost half of the cities in the US cannot directly benefit from the recent Supreme Court ruling about tax on internet sales, although this is applauded as a major benefit for state and local governments. Although the majority of cities rely on property taxes, TELs impose limits on the growth rate of property taxes and thus the recovery of real estate market does not translate into the growth of tax revenue. Coupled with stagnant growth of state aid to cities, cities are left with fewer resources at the same time they are asked to do more.

Although the federal government plays a lesser role in shaping municipal fiscal decisions, changes at the federal level can have an impact on city revenues, directly by reduced federal aid and indirectly by adjusting the federal tax code and imposing mandates. The newly established cap on SALT deductions does not affect state and local tax revenues directly. However, high-tax states and cities may lose some affluent taxpayers and hence part of their tax bases. The overall impact on state and local finances will be small given that more than half of the taxpayers will not be affected by this cap.

Cities vary substantially in their revenue structure, economic condition and intergovernmental context. The impact of misaligned revenue systems, state control, and federal intrusion is and will be heterogeneous across cities in the American federal system. As a consequence, caution is advised when generalizing the findings from this paper to a particular municipal government.

## References

- Afonso, Whitney B. 2015. "Leviathan or Flypaper: Examining the Fungibility of Earmarked Local Sales Taxes for Transportation." *Public Budgeting & Finance* 35 (3): 1–23.
- Black, Henry Campbell, Bryan A. Garner, and Becky R. McDaniel. 1999. *Black's Law Dictionary*. Vol. 196. West Group St. Paul, MN.
- Buchanan, James M. 1963. "The Economics of Earmarked Taxes." *Journal of Political Economy* 71 (5): 457–469.
- Carroll, Deborah A. 2009. "Diversifying Municipal Government Revenue Structures: Fiscal Illusion or Instability?" *Public Budgeting & Finance* 29 (1): 27–48.
- Clark, Anna Fountain, and Evgenia Gorina. 2017. "Emergency Financial Management in Small Michigan Cities: Short-Term Fix or Long-Term Sustainability?" *Public Administration Quarterly* 41 (3): 532–68.
- Deran, Elizabeth. 1965. "Earmarking and Expenditures: A Survey and a New Test." *National Tax Journal* 18 (4): 354–361.
- Dye, Richard F., and Therese J. McGuire. 1992. "The Effect of Earmarked Revenues on the Level and Composition of Expenditures." *Public Finance Quarterly* 20 (4): 543–556.
- Hendrick, Rebecca, and Shu Wang. 2018. Use of Special Assessments by Municipal Governments in the Chicago Metropolitan Area: Is Leviathan Tamed? *Public Budgeting and Finance*. <https://onlinelibrary-wiley-com.proxy2.cl.msu.edu/doi/epdf/10.1111/pbaf.12190>
- Hoene, Christopher, and McFarland Christiana. 2015. Cities and state fiscal structure 2015. National League of Cities. <http://www.nlc.org/resource/cities-and-state-fiscal-structure-2015> (accessed June 3, 2017).
- Krane, Dale, Platon N. Rigos, and Melvin Hill. 2001a. *Home Rule in America: A Fifty-State Handbook*. Cq Press.
- Langley, Adam. 2016. "Methodology Used to Create Fiscally Standardized Cities Database." Working Paper WP16AL1, Lincoln Institute of Land Policy.
- Mead, Timothy D. 1997. "Federalism and State Law: Legal Factors Constraining and Facilitation Local Initiatives." *Handbook of Local Government Administration*, 31–45.
- Mullins, Daniel R., and Bruce A. Wallin. 2004. "Tax and Expenditure Limitations: Introduction and Overview." *Public Budgeting & Finance* 24 (4): 2–15.
- Oakland, William H. 1985. Earmarking and decentralization. In Proceedings of the Seventy-Seventh Annual Conference 1984, National Tax Association-Tax Institute of America, 274–277.
- Pagano, Michael A., Christopher Hoene, Wu Yonghong, Shu Wang, Yu Shi, and Nisa Yazici. 2016. The fiscal policy space of cities: A comprehensive framework for city fiscal decision making. Chicago: University of Illinois at Chicago.
- Pagano, Michael A. and Christopher W. Hoene, "City Budgets in an Era of Increased Uncertainty: Understanding the fiscal policy space of cities," July 2018, Brookings Metropolitan Policy Program at: [https://www.brookings.edu/wp-content/uploads/2018/07/20180718\\_Brookings-Metro\\_City-fiscal-policy-Pagano-Hoene-final.pdf](https://www.brookings.edu/wp-content/uploads/2018/07/20180718_Brookings-Metro_City-fiscal-policy-Pagano-Hoene-final.pdf)
- Perez, Arturo. 2008. Earmarking state taxes. National Conference of State Legislatures. <http://www.ncsl.org/documents/fiscal/earmarking-state-taxes.pdf> (accessed December 30, 2016).

- Richardson Jr, Jesse J. 2011. “Dillon’s Rule Is from Mars, Home Rule Is from Venus: Local Government Autonomy and the Rules of Statutory Construction.” *Publius: The Journal of Federalism* 41 (4): 662–685.
- Richardson, Jesse, Meghan Gough Zimmerman, and Robert Puentes. 2003. *Is Home Rule the Answer? Clarifying the Influence of Dillon’s Rule on Growth Management*. Washington, D.C.: Brookings Institution Center on Urban and Metropolitan Research.
- Skidmore, Mark, and Mehmet S. Tosun. 2011. “Property Value Assessment Growth Limits, Tax Base Erosion, and Regional in-Migration.” *Public Finance Review* 39 (2): 256–287.
- Wang, Shu. 2018. “Effects of State-Imposed Tax and Expenditure Limits on Municipal Revenue Reliance: A New Measure of TEL Stringency with Mixed Methods.” *Publius: The Journal of Federalism* 48 (2): 292–316.
- Welch, Jill. 1998. “Home Rule Doctrine and State Preemption—The Iowa Supreme Court Resurrects Dillon’s Rule and Blurs the Line Between Implied Preemption and Inconsistency, *Goodell v. Humboldt County*. 575 NW 2D 486, Iowa 1998.” *Rutgers Law Journal* 1548.
- Wolman, Hal, Robert McManmon, Michael Bell, and David Brunori. 2008. “Comparing Local Government Autonomy across States.” *George Washington Institute for Public Policy, Washington, Working Paper* 35.