State Rules and City Institutions:
Re-Examining the Effects of Tax and Spending Limits

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The new institutionalism in economics and political science has returned scholarly attention to rules, and emphasized the way rules shape individual behavior and, in turn, public policy outcomes. While the new institutionalism has formalized the idea of a hierarchy of rules that step from to the substantive to the constitutional level, it has neglected to consider the levels of government, each of which has its own rule hierarchy. We propose a simple conceptual model that integrates these two ideas, and suggest that this incorporation may help account for differences in cities' implementation of state mandates. We test this proposition by examining cities' responses to state-imposed limits on municipal powers to tax or spend (TELs).

City constitutional-level rules, specifically form of government, may create incentives for local officials’ fiscal choices to depart from the preferences of local taxpayers if those rules create “high-powered” incentives that allow individual political gains from transactions (Frant 1996). In this case, the city's decisions to tax and spend may more closely resemble the Leviathan model of public finance, where self-interested officials are strategic actors that use the power of the purse for personal gain, and agency failure is the norm (Oates 1985). We expect that the impact of state-imposed TELs will be greatest in these cases.

On the other hand, if local institutions create only low-powered incentives, local fiscal policies may be more congruent with citizen preferences, and TELs may have little impact. This theoretical framework is tested by identifying the impacts of state rules, local political institutions, and service demand on property tax dependence in the nation’s large cities from 1975-1995. The results reported here demonstrate that the local choice of government form influences the effect of certain state-level rules.

Nested Levels of Governments
Studies of intergovernmental relations often concentrate on the levels of government imposing and implementing rules, investigating the way that higher-level governments use mandates or incentives to affect the operations and policy decisions of lower-level governments (Chubb 1985, Wright 1988, O’Toole 1993). The new institutionalism, on the other hand, categorizes levels of rules according to their affect (Ostrom 1990, 1994 Brennan and Buchanan 1980). Constitutional-level rules establish the overall rules of the game and lay out the basic system of governance. Substantive rules deal with a specific policy area such as the environment or taxation. Operational rules guide specific, day-to-day decisions and often concern allocating and managing resources. Ostrom describes this hierarchy as “nested,” evoking the image of lower level, substantive rules held in a structure of higher-level, overriding constitutional rules.

Constitutional-level rules delineate the framework for legitimate action, including the procedures for formulating other rules (such as those that concern specific policy areas) and for aggregating choices (Brennan and Buchanan, 1980; Ostrom, 1990). Form of government provisions (such as unicameral or bicameral legislatures), electoral scheme (such as district or at-large elections) and provisions for direct democracy (such as referendum requirements or the allowance of citizen’s initiatives) are all examples of constitutional-level rules. Because institutions are nested, policy outcomes depend not only on the provisions of the substantive rule but also on the opportunities and constraints created in the constitutional-level rules.

Incorporating levels of government into the levels of rules framework may point the way to a model of state-local relations that can account for differences in the implementation and effect of state-enacted local policies. Directly and indirectly, states shape the constitutional and substantive rules that affect local governments. State constitutional level rules include provisions for the creation of lower-level governments, including the incorporation of municipalities. It may be more accurate to view state-municipal relations as a system of nested levels of institutions.
nested levels framework diagramed in Figure 1 may help to explain differences in policy implementation when state substantive laws constrain city choices.

Figure 1 here

Provisions for municipal home rule are examples of constitutional-level rules operating at both the state and local levels. Dillon’s rule holds that local governments are “creatures of the state” and can only undertake activities the state specifically authorizes. Nearly all states, however, have made provisions for municipal home rule, enabling their cities to enact charters that establish their choice of governance structures and rules of governance. Charters may also broaden municipal powers beyond those expressly granted by the state (Krane, Rigos and Hill 2001). Form of government is one of the constitutional-level questions addressed in municipal charters. City charters express constitutional-level rules that, among other things, define citizens’ rights to have their preferences included in public decisions (Maser 1985, 1998; Miller 1985). In contrast, the tax and spending limits that states impose on cities are substantive-level rules that establish state preferences for city actions. Even with home rule cities, state laws are primary, and states can enjoin cities from taking some actions, and require them to take others.

If constitutional-level rules affect outcomes, and cities, through their charters, adopt different constitutional level rules, we should expect different policy outcomes when states impose substantive laws upon cities. Local governance structure mediates the influence of exogenous constraints such as state laws by shaping the incentives of local actors. Viewing differences in policy outcomes from the standpoint of nested levels of institutions promises to provide more coherent theoretical foundations for the study of intergovernmental policy implementation and to allow for more nuanced analyses of urban policy. In this instance, it may act as a bridge between competing models of municipal finance.
Local Fiscal Behavior and Models of Government

Two competing models of local government fiscal behavior, a median-voter/benevolent dictator model and a Leviathan/budget maximizing bureaucratic model, have been called on to explain government fiscal behavior (Shapiro and Sonstelie 1982). Both models share the assumption that local officials are self-interested. Under the first model, however, local officials, intent on reelection, seek to maximize the community-wide benefits of fiscal policy choices by making decisions that are consistent with the preferences of the median voter. The median voter model assumes that local politics work as a constraint, because voters hold elected officials accountable for their decisions to tax and spend. Officials whose tax and spending decisions are far from those of the median voter will be ousted from office, and replaced with officials whose decisions are closer to the median voter preferences (Chicoine, Walzer and Deller 1989). Efficiencies are realized as potential residents choose among competing cities, selecting the one where the tax and service package best meets their preferences (Tiebout 1956). Municipal power to zone land means that city officials can control the density and intensity of future development to assure that new development will add to, or at least not subtract from, the local tax base (Hamilton 1975). Where these assumptions are met, there will be no need for state TELs because tax and expenditure levels already reflect the preference of the median voter.

The Leviathan model, on the other hand, describes a government driven to maximize its tax “take” (Oates 1985). Since the forces that compel politicians and bureaucrats to maximize revenues are intrinsic to politics, only exogenous rules can limit taxing and spending (Brennan and Buchanan 1980). The TELs that states impose on cities are an example of such a rule, and TELs would be expected to have significant impacts on local fiscal policy decisions. Empirical findings that TELs are effective in reducing revenues or expenditures have been cited as prima facia evidence of Leviathan government (McGuire 1999).
The median voter and the Leviathan models speak to the importance of politics in decisions to tax or spend. Ironically, each ignores differences in political institutions among cities, and assumes that local governments behave monolithically, as either fiscally-restrained, median-voter-pleasers or as a tax-maximizing, citizen-exploiters. Similarly, Tiebout’s (1956) model assumes local decision makers are apolitical, and that the tax and service packages they offer are intended to “attract enough residents to stay solvent” (Fischel 2000, p. 9). Perhaps because of the focus on residents shopping among communities, tests of the Tiebout model have tended to address the demand side, leaving the supply side of the model, which would tackle political distinctions among local governments, less fully developed (Fischel 2000).

Similarly, in an intergovernmental context, tests of the effects of state-imposed tax and spending limitations have tended to view the local policy outcomes in terms of environmental constraints, either restrictions from above or demands from within. In empirical studies, distinctions among state restrictions have been more finely drawn, to account, for example, for the stringency of the tax or spending limit (Shadbegian 1998, 1999). Variations in local service cost, demand and taste have been accounted for (Preston and Ichniowski 1991). Despite recognizing distinctions in the nature of higher-level rules and in the factors of demand, the models ignore institutional variations in governance among cities.

States and cities each have constitutional-level rules that may influence the implementation of substantive policy. Home rule cities’ charters include constitutional level rules that incorporate provisions for government form (mayor-council or council-manager). State rules may provide options for forms of municipal government, but the selection of local governance institutions is primarily a local choice, expressed in the city charter. Changes to the form of government were first introduced in the hope that changing the rules of governance would change the outcomes of the government to ones that more closely conformed to the preferences of the reformers (Knott and Miller 1987). Like any institution, cities’ constitutional-level rules create
incentives for specific behaviors (Clingermayer and Feiock 2001). Some, “high-powered”
incentives produce benefits that can be directly realized by the actors. In markets, high-powered
incentives lead to innovation and enhanced productivity, as entrepreneurs respond to the profit
motive. In politics, high-powered incentives lead to political opportunism and rent-seeking, as
actors seek personal advantage through public means (Frant 1996; Feiock and Kim 2001). Many
Progressive-era municipal reforms were intended to reduce politicians’ ability to deliver
particularistic benefits, or, from a transaction costs perspective, to replace high-powered
incentives with low-powered incentives (Frant 1996). One reform proposal was council-manager
form of government, in which an elected council and their employee, the manager, have distinct
responsibilities that separate articulating from executing policy. The council establishes general
policy and is accountable to the voters, much like a board of directors answers to the stockholders
of a corporation. Policies are carried out by a city manager, who plays a role like the
organization’s CEO. This form of government is a potential alternative to the strong mayor form,
where the elected mayor and her employees are responsible for policy making as well as for
administration.

Following the work of Banfield and Wilson (1963), Lineberry and Fowler (1967) found
empirical support for the proposition that council-manager government insulates governing from
“private regard” demands. The institutional rules of the game in reform governments provide
incentives for an emphasis on citywide issues and constituencies and place constraints on
 politicization of fiscal issues. Conversely, in the unreformed context, the rules provide incentives
for the emergence of narrow issues and constituencies and place constraints on the role of
professional expertise in informing public decisions (Sharp 1997; Feiock and Kim, 2001). The
popularity of the political institutions prescribed by the municipal reform movement reached its
zenith about the middle of this century. Over the last few decades a small but significant number
of cities have moved to (or back to) strong mayor government (Ruhill 1999).
As a level of government nested within the states, cities are granted the power to tax some kinds of revenues, but forbidden from taxing others. Many states allow cities to employ sales taxes, and a few states enable cities to impose income or payroll taxes. All states, however, permit their cities to tax property. In fact, the property tax has evolved into an almost exclusively local government tax (Fisher 1996). However, most states also constrain cities' powers to tax property. States rely on three broad kinds of restrictions: limits on the tax rate, assessment increases or the city’s total property tax “take” (known as levy limits). State-imposed TELs have been credited with lowering local governments' reliance on property taxes, diversifying local revenue streams and slowing the growth rate of local spending and revenues (Mullins and Joyce 1996; Joyce and Mullins 1991; Lowery 1986; Shadbegian 1998).¹ The success of state-imposed TELs is taken as proof that, absent exogenous constraints, local governments would exploit their citizens through excessive taxation. Tax limits have been found to differ in their efficacy. Rate or assessment limits are seen as the least effective restraints, since each controls only half the property tax equation (Lowery 1983).

We suggest that when cities’ constitutional-level institutions create high-powered incentives, local fiscal behavior may more closely correspond to the Leviathan model because self-interested political actors have more reasons and means to pursue individual goals at the public expense. On the other hand, when cities’ constitutional-level institutions create low-powered incentives, fiscal behavior is more likely to correspond to the median voter model, because self-interested political actors have fewer inducements and means of attaining individual goals at the public expense. These differences in city institutions lead to differences in our expectations of the effects of state substantive rules. Specifically, we anticipate that state-imposed tax limits will have greater effect when they are imposed on cities that have mayor council form of government and less effect when imposed on cities that have council-manager form of government.
Approach

We test two simple models to evaluate the effects of TELs on cities’ revenue choices, using pooled cross sectional time series data. The first estimates the base model and examines the effects different types of tax limitations have on property tax dependence. The second model examines the role that local governance institutions play in mediating the effect of state TELs on local property tax reliance. Observations are included for each year from 1975 through 1995 for a panel of all U.S. cities with a 1989 population of at least 75,000.

We chose property tax reliance as our dependent variable because of its importance to citizens, bureaucrats and politicians. For homeowners, property taxes provide a highly visible tax price for public services. Clear prices for public services facilitate citizens' choices among candidates for local political office as well as Tiebout sorting among communities. Elected officials may seek to rely on property taxes because they offer both a stable revenue base and considerable discretion over revenues. In the absence of rate limits, elected officials can increase or decrease the tax rate to bring in the levels of revenues called for in the annual budget.

The pooled time series models were estimated using ordinary least squares (OLS) with panel corrected standard errors (PCSE). A panel specific first-order autoregressive process was employed to represent the pattern of serial correlation of errors operating within panels (Beck and Katz 1996). The data is transformed to produce serially independent errors and the Prais-Winsten transformation is employed. This procedure allows for the use of the first observation in each panel when estimating OLS with PCSE, avoiding the loss of observation due to the differencing procedure (Gujarati, 1995). The OLS parameter estimates resulting from the estimation with PCSE are consistent, and the estimation process deals with panel-level heteroscedasticity and contemporaneous spatial autocorrelation.

The dependent variable, property tax reliance, is the percentage of own-source city revenues derived from property taxes. In each model, our analysis controls for service demand by
including population, the population in poverty, the white population, home ownership and personal income. Each model incorporates some basic controls for fiscal differences among cities including long-term debt as well as sales or income tax authority.

TELs are measured as a dichotomous variable for each of the restrictions that targets property taxes (levy limits, rate limits, and assessment increase limits) for each city-year observation. They are assigned the value of 1 when the limit is present. Similarly, city income tax and sales tax powers are each measured as 1 when states have granted the city the authority to access that tax base. Government structure is coded as 1 to designate the mayor-council form of government and coded 0 to designate the council-manager form. In addition to estimating the additive effects of TELs and form of government, we include interaction terms to capture the effect of both mayor-council form of government and the various property tax restrictions.

Data regarding state laws restricting local revenue powers were gathered up to 1992 by Mullins and Cox (1995) for the United States Advisory Commission on Intergovernmental Relations (ACIR). These data have been updated by reviewing the annotated statutes of each state, and cross-checking these results with data provided by the Municipal Yearbook and by a survey of the state’s office of the League of Cities/Municipal League. Only state TELs affecting cities are included. A similar process was used to fix the dates for states’ grants of sales or income tax powers to cities, relying on the ACIR’s Fiscal Federalism series.

City financial and population data were drawn from published and online reports provided by the Bureau of the Census and various volumes of the County City Data Book. Data regarding the form of government are taken from surveys conducted by the International City Manager Association (ICMA) in 1981, 1986, 1991 and 1996. The 1981 survey included questions about form of government in 1976. When changes occurred, the surveys collected information on the year in which the change was made. The average response rate for the ICMA surveys was almost 80 percent, but some data for cities in the panel were missing in some years. Missing
observations were recovered by relying on the general assumption that changes of city
government structures are not readily reversed. If reported structures from the periods before and
after the missing observation were identical, we coded the same form for the missing period. This
assumes that cities did not adopt a governance structure, repeal it, then readopt it between the
observations. This assumption may introduce some measurement error, but there is no reason to
believe the error is systematic. As a result, it should not introduce bias. If reported structures from
the periods before and after the missing observation were different or data were missing for the
beginning or ending period, we relied on various ICMA and online resources to complete the data
based on the most proximate year.

Analysis

The results reported in Table 1 supports the proposition that state rules affect municipal
fiscal choices. Several factors, including state grants and restrictions of local power (particularly
tax authority and TELs) and environmental conditions (especially the population in poverty),
reduce property tax reliance. In the base model estimated in Table 1, the effects of levy limits and
restrictions on assessment increases are greater in magnitude and statistical significance than are
the effects of property tax rate limits. This result suggests that state imposed local tax limits
reduce cities’ dependence on property taxes, but only assessment limits and levy limits produce
effects that are statistically different from zero. When other factors are held constant, state limits
on property assessment lower cities’ property tax reliance by about seven percent, on average,
while levy limits reduce cities’ reliance on property taxes by three percent.

Table 1 here

The results reported in Table 2 demonstrate that city constitutional-level rules influence
both city fiscal choices and the outcomes of state-imposed institutional constraints. As in the base
model, the size of the poverty population and additional tax authority each depress city property
tax reliance. Accounting for form of government reveals that cities with mayor-council
government rely more heavily on property taxes for their own-source revenues, consistent with
our theory. On average, cities with the mayor-council form of government obtain a little over
eight percent more of their own-source revenues from property taxes than council-manager cities
do. Since property taxes offer the greatest flexibility of the revenues potentially available to local
governments, this finding suggests that, unlike council-manager governments, the mayor-council
form of government creates incentives that lead political actors to prefer to rely more heavily on
the revenue source that gives them the greater amount of discretion.

Table 2 here

The results of the interaction terms suggest that form of government matters not only in
cities’ revenue choices but also in the effect of state rules intended to limit cities’ fiscal choices.
When cities have both rate limits and mayor-council form of government, the city’s reliance on
property taxes drops by an additional 7.7 percent, nearly negating the difference that governance
structure makes to revenue reliance. The effects of levy limits and mayor council form of
government are not statistically different from zero, but the combination of assessment limits and
mayor council form actually leads to a greater reliance on property taxes.

Rate limits may offer particular opportunities that interest politicians in mayor-council
cities, and this appeal may make rate limits an effective restriction in these cities. Restrictions on
assessment increases offer limited incentives to self-interested politicians because property
assessment is typically beyond their influence, depending on changes in property values, which
are often ascertained by assessors beyond the mayor’s control. Ironically, mayor-council cities
with assessment limits average an 11 percent higher reliance on property taxes, holding other
factors constant. It may be that assessment limits fail to act as an effective restriction in the high-
powered incentive environment of mayor-council cities. Since levy limits are placed on the total
property tax “take,” they provide limited opportunity to deliver the particularistic benefits that
appeal to self-interested politicians. Rate limits, however, offer the opportunity to claim credit for a clear outcome. For many voters, the link between a levy limit or a restriction on assessment increases and their property tax bills may seem a bit remote (Lowery 1985). Rate limits seem to offer more predictable outcomes, and perhaps more importantly for self-interested politicians, a lower tax rate is a benefit that can be delivered to individual voters.

**Discussion**

Recent years have seen revived interest in how local level institutions operate to shape the incentives of political actors (Frant 1993; Maser 1998; Feiock and Carr 2001). At the same time the role of state laws in shaping home rule powers has captured increased scholarly attention. (Krane, Rigos and Hill 2001). A theory of intergovernmental institutions promises to provide a framework to bridge these literatures and provide a research agenda for the examination of how state level rules shape local choices in a variety of policy areas.

Over the past decade, a growing body of theoretical and empirical work has enhanced our understanding of the importance of institutions. We suggest that institutions and their effects may be best understood as nested systems. In many states general laws set broad parameters for allowable systems of local governance and also establish state preferences for local policies (such as tax or spending levels). Local institutional choices establish the way in which local policies will be made, the constituencies that will be served and, our findings suggest, the way in which state level preferences are implemented.
Constitutional level rules establish general rules of governance, such as form of government, the parties authorized to make legitimate decisions, or how choices will be aggregated.

Substantive rules deal with specific types of decisions such as tax levels or environmental regulation.

Operational decisions are the choices made in light of the higher level rules (e.g., City A’s property tax rate in the present year).
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Table 2: State Restrictions and City Property Tax Reliance, 1975–1995
Institutional Effects Model

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N of Cities 267
Observations 6444
Wald Chi² (12) 3664.14
Prob>Chi² 0.0000
Bibliography


I These studies examined TELs’ effects on the aggregation of local governments in each state, an operationalization that may mask some of the consequences of tax limits. Different kinds of local governments typically depend more on some kinds of revenues than on others. Typically, special districts rely heavily on fee revenues, and school districts on property tax dollars (Wright 1988). Evaluating the revenue mix of all local governments may say as much about the structure of states’ systems of local governance as it does about local systems of revenue. Perhaps more importantly, analyzing revenue shifts among all types of local governments masks changes brought about from education finance reform that took place concurrently with the tax revolt. The purpose of education reform was to even out funding disparities among school districts by lowering the districts’ reliance on property taxes. In many states, efforts to change local property tax reliance came from two separate sources (TELs or education reform) at roughly the same time, frustrating definitive efforts to assign responsibility for changes in local property tax reliance (McCabe 2000). When the effects of TELs are examined by type of government, the empirical evidence makes finer distinctions about the restrictions’ effects.

II In a few cases, tax limits are not imposed on all cities. For example, New York’s limit on assessment increases only applies to jurisdictions with a population of at least one million, a restriction that targets the measure to New York City. Illinois’ property tax rate limits do not apply to home rule cities. For the seven Illinois cities in our sample, the rate limit only applies to Rockford, which lost its home rule status in 1978 (authors).