NESTED LEVELS OF INSTITUTIONS
State Rules and City Property Taxes

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The new institutionalism concentrates on the nature and effects of rules, and intergovernmental relations on the levels of government. This article integrates these foci to present a model of nested institutions and levels of government, focusing on constitutional and substantive rules of governance in states and municipalities. The authors contend that cities' constitutional rules (specifically their governance arrangements) shape local actors' incentives and influence their implementation of state mandates. They argue further that the mere presence—not the actual evocation—of these rules casts a shadow that defines the actors' decision space and that broad distinctions among laws have profound implications for the actors' choices. They support this explanation by empirically testing propositions derived from the framework regarding property tax dependence in large cities between 1975 and 1995.

Keywords: *property tax; form of government; intergovernmental; local governance; mandate*

The new institutionalism in economics and political science has returned scholarly attention to rules, emphasized the way rules shape individual behavior, and in turn, public policy outcomes. Although the new institutionalism has formalized the idea of a hierarchy of rules that step from 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 draws from theoretical

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advances in the legal, economics, political science, and public administration literatures. We suggest that this incorporation may help account for differences in cities' implementation of state mandates. The thesis is simple: Institutions—at both the state and city levels—matter. Specifically, we suggest that cities' constitutional-level rules influence their implementation of state-imposed substantive rules. This proposition is tested by examining cities' responses to state-imposed limits on municipal powers to tax or spend from the perspective of decision making in the shadow of the law (Jacob 1992). This theory and its test call into question the hegemony of the Leviathan model of public finance, where public officials use the power of the purse in their political self-interest and agency failure is the norm (Oates 1985).

Even when not specifically invoked, the law casts a shadow that shapes the expectations and incentives of decision makers and limits the space within which they make decisions. 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 their actions (Frant 1993, 1996). When high-powered incentives prevail, the city's decisions to tax and spend may more closely resemble the Leviathan model. It is expected that the impact of state-imposed tax and expenditure limits (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 affects 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 how state-level rules impact city fiscal policy.

NESTED LEVELS OF RULES

Intergovernmental relations and the new institutionalism each have a distinct theoretical focus that simplifies the complexities of implementing mandates. Studies of intergovernmental relations often concentrate on the levels of government imposing and implementing rules, investigating higher-level governments' use of mandates or incentives to direct 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 effect (Ostrom 1990; Brennan and Buchanan

1980). Constitutional-level rules establish the overall rules of the game and lay out the basic system of governance. Like a computer's operating system, constitutional-level rules matter because they provide overriding standards that control how specific choices can be made (Ostrom 1990). Substantive rules deal with a specific policy area such as the environment or taxation. Ostrom describes this hierarchy as "nested," evoking the image of lower-level, substantive rules held in a structure of higher-level, overriding constitutional rules. Operational decisions (such as setting the city's property-tax rate) are made within the decision space established by the boundaries of both constitutional and substantive 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). These rules are part of a relational contract between those who govern and those who are governed (Maser 1998). Many constitutional-level rules contend with the need for cooperative action to secure joint benefits. Cooperation is essential for society to attain benefits that individuals, acting alone, either cannot or will not provide (Olson 1965). Cooperation avoids the tragedy of the commons, in which all-out competition among individuals delivers poor results (Harden 1968; Ostrom 1990). Cooperation, however, does not come easily, and many constitutional-level rules establish procedures that address potential threats to cooperative action. Division problems—questions about the allocation of costs and benefits—may jeopardize cooperative action when individuals with differing preferences compete to gain benefits and avoid costs. Because preferences can change over time, constitutional-level rules typically address division problems through provisions for responsive representative government. Majority rule and electoral schemes (i.e., district or at-large elections) are examples of constitutional-level rules for dealing with division problems.

Because institutions are nested, policy outcomes depend not only on the substantive rules' provisions but also on the opportunities and constraints created in the constitutional-level rules. Policy choices take place "against a background of previously existing mutual understandings that are not brought into question" (Heckathorn and Maser 1987, 145). As a result, every decision "is prestructured by prior understandings and in turn each structures future negotiations by creating the context in which they occur" (Heckathorn and Maser 1987, 145).

The new institutionalism has become increasingly sophisticated in considering the purposes behind different types of rules and how they operate. However, it has failed to consider how different levels of government figure into the rules structure, and intergovernmental relations have yet to integrate

the role of rules into the levels of government. 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 outcomes 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 creating 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. The nested-levels framework diagramed in Figure 1 may help to explain differences in policy implementation when state substantive laws constrain city choices.

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 (Krane, Rigos, and Hill 2001). Home rule addresses a division problem. Recognizing that municipalities and their residents' preferences differ, home rule empowers these residents to ratify their own, city-level constitutions (city charters). Essentially, home rule empowers cities to address threats to cooperation (as they understand them) in the context of their communities. In the process, city charters express constitutional-level rules that, among other things, address responsiveness by defining citizens' rights to have their preferences included in public decisions and defection by crafting governance institutions that either hinder officials' self-interested actions or oust failing officials from office (Maser 1985, 1998; Miller 1985). Form of government is one of the constitutional-level questions addressed in municipal charters.

The tax and spending limits that states impose on cities, on other hand, are substantive-level rules that establish state preferences for city actions. These TELs put a ceiling on city choices to tax and spend, replacing city preferences with state preferences. Even with home-rule cities, state laws are primary. States can enjoin cities from taking some actions and require them to take others. Sometimes obviously, sometimes subtly, state laws shape city choices.

THE SHADOW OF THE LAW

The law's "shadow" has been used to explain why, in civil disputes, negotiations are conducted and agreements reached within the framework estab-

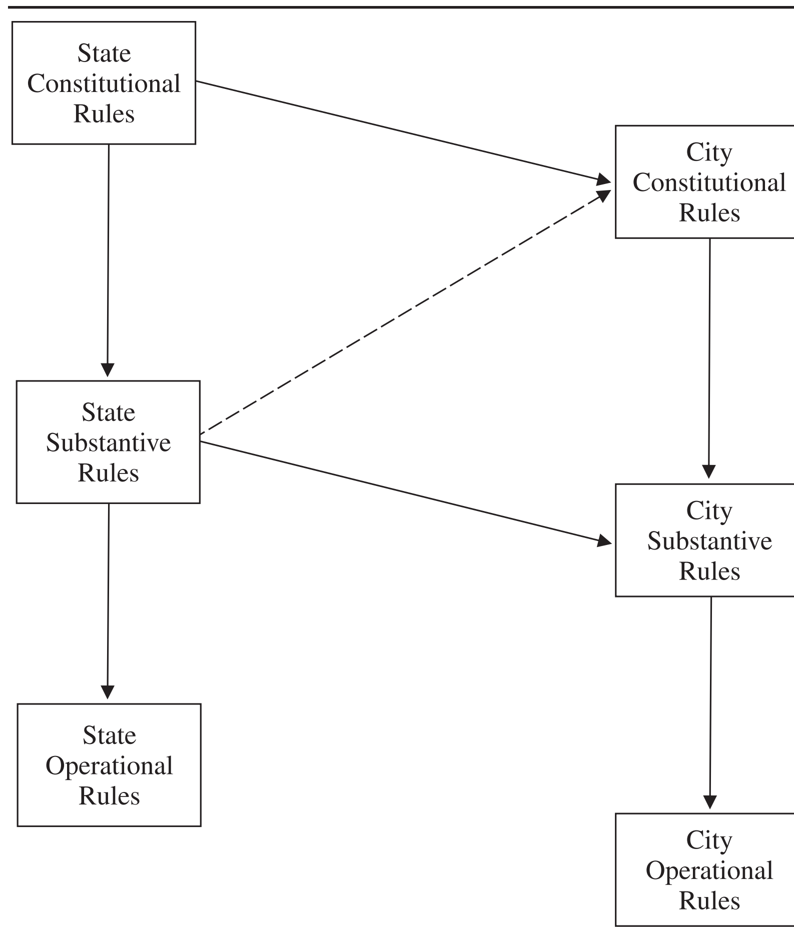

Figure 1: Levels of Rules and Levels of Governments
NOTE: Constitutional-level rules establish general rules of governance such as form of government, the parties authorized to make legitimate decisions, or how choices will be aggregated. Substantive-level rules deal with specific types of decisions such as tax levels or environmental regulation. Operational-level decisions are the choices made in light of the higher-level rules (for example, City A's property-tax rate in the present year).

lished by the law *even when legal proceedings are not under way*. In divorce negotiations, for example, pretrial settlements between the parties mirror the statutory provisions for spousal support, child custody, and property division. The simple presence—not the ultimate application—of the law casts a shadow that defines the decision space for making choices (Mnookin and Kornhauser 1979). The law sets the boundaries for disputants to understand

their positions, frame their grievances, and stake their claims (Jacob 1992). Research addressing the shadow of the law has focused on individual decisions made in the context of broad, legal provisions, whereas the relational contract work has concentrated on the nature and intent of those provisions. Combining these approaches makes it possible to bridge the difference between the societal-level concerns of crafting institutions and the individual-level concerns of decision making in the face of institutional constraints.

Game theory and experimental research provide support to the model's chief claims—that the mere existence of the law is central to defining the space for action and that basic differences in the laws themselves lead to different consequences. Game theoretic tests have focused on differences in the parties' possession of private information, attitudes toward risk, expectations of winning in one-shot games (Cooter, Marks, and Mnookin 1982; Kennan and Wilson, 1993; Baird, Gerner, and Picker 1995), and repeated negotiations (Spier 1992). Direct empirical tests of the shadow-of-the-law's effects on policy decisions have been limited (Main and Park 2000). Cities' responses to state-imposed TELs offer an opportunity to assess predictions of the shadow-of-the-law's effects empirically.

City operational decisions are made within the shadow of the constitutional-level and substantive laws erected by the state, as well as within the shadow of the constitutional-level rules contained in the city charter. If constitutional-level rules influence outcomes and cities (through their charters) adopt different constitutional-level rules, policy outcomes will vary when states impose substantive laws upon cities. In other words, cities will respond to mandates differently and how they react will depend, in part, on the cities' governance structure. 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 this standpoint provides a coherent theoretical foundation for the study of intergovernmental policy implementation that allows for more nuanced analyses of urban policy.

MODELS OF GOVERNMENT

States and cities each have constitutional-level rules that may influence the implementation of substantive policy. Each casts its shadow. 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 government outcomes to ones that more closely conformed to the reformers' preferences (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 realized by the actors directly. In markets, high-powered incentives lead to innovation and enhanced productivity, as entrepreneurs respond to the profit motive and reap individual rewards. In politics, high-powered incentives raise the risk of defection through political opportunism and rent seeking, as actors seek personal advantage through public means (Frant 1996; Feiock and Kim 2001). Elected officials, for example, face high-powered incentives to either please their constituency or face defeat at the polls. As a result, their policy choices are apt to differ from the choices of appointed officials. Many Progressive-era municipal reforms addressed the defection problem. These reforms were intended to reduce politicians' ability to deliver particularistic benefits, replacing high-powered incentives with low-powered incentives (Frant 1996, 1993). One reform proposal was the 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, whereas the city manager simply carries out that policy. This form of government is a potential alternative to the mayor-council form, where elected mayors and their employees are responsible for policy making as well as administration.

State home-rule provisions addressed fundamental division problems (reflected as differing preferences among municipal residents) by empowering their cities to choose their own form of government. Home rule allowed cities to forge institutions that address threats to cooperation as the players in each city understood them and the municipal-reform movement offered two major options. The council-manager form addressed a defection problem (Maser 1998) by lowering the incentives for opportunistic decisions. The mayor-council form addressed a responsiveness problem and cast a shadow that broadened the officials' decision space by increasing their incentives to behave opportunistically and deliver particularistic benefits.

Although the language is different, past research has confirmed these basic ideas. 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 regarding" demands. The institutional rules of the game in reform governments provide incentives for emphasizing citywide issues and constituencies and place constraints on politicizing fiscal issues. Conversely, in the unreformed context, the rules provide incentives for narrow issues and constituencies to emerge and place

constraints on the role of professional expertise in informing public decisions (Sharp 1997; Feiock and Kim 2001). By the mid-1900s, the popularity of the political institutions prescribed by the municipal reform movement had reached its zenith. During the past few decades, a small but significant number of cities have moved to (or back to) strong mayor government (Ruhill 1999).

Cities are granted the power to tax some kinds of revenues but are 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). In contrast to income or sales taxes, the revenues of which fluctuate with changes in the economy, property offers a relatively stable tax base, and changes in property-tax revenues can be made through city action to raise or lower the tax rate. Under the current structure, only the property tax has the potential to be a totally local tax, from the political decision of setting the tax rate through the tax's collection and administration (Fisher 1996). Indeed, the classic model of municipal finance envisions cities' estimating their budget requirements each year and adjusting their property-tax rates to raise the needed revenue (Mikesell 1999).

Most states, however, also constrain their cities' powers to tax property. In these cases, city officials' annual budget and revenue decisions are made in the shadow of the failure to stay within the state-imposed limits (see Shariff 2003). States rely on three broad forms of restrictions, each of which, to varying degrees, reduces the cities' discretionary power to raise revenue through property taxes.[1] Rate limits, the most common restriction type, cap the rate at which cities can tax property. Levy limits place a ceiling on the city's total property-tax "take." Last, assessment restrictions limit increases in the property tax's base—the assessed value of property—and apply whether those increases occur through changes in assessment practices or through the appreciation of property values (Joyce and Mullins 1991).

These 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 (Joyce and Mullins 1991; Lowery 1986; Shadbegian 1998).[2] Tax limits have been found to differ in their efficacy. Rate or assessment limits are seen as the least effective restraints, because each controls only half of the property-tax equation (Lowery 1983). The shadow of the law suggests that these basic differences among the restrictions will lead to different outcomes, as decision makers shape their choices in response to the law's general outline.

MODELS OF LOCAL FISCAL BEHAVIOR

The perceived need for state restrictions, and the interpretation of those restrictions' effects, stem from two competing models of local government fiscal behavior—a median-voter/benevolent-dictator model and a Leviathan/budget-maximizing-bureaucratic model (Shapiro and Sonstelie 1982). Both models assume that local officials are self-interested and intent on reelection. Under the median-voter model, however, local officials attempt to maximize the communitywide benefits of fiscal policy choices by making decisions that are consistent with the preferences of the median voter. In the median-voter model, local politics work, at least retroactively, and through elections, voters hold officials accountable for their decisions to tax and spend. Officials whose fiscal choices are far from the median voter's preferences will be ousted from office, to be replaced with officials whose decisions more closely resemble what the median voter wants (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). Because cities have zoning powers, 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, state TELs are not needed to curb city taxing and spending. Instead, local politics are the constraining force that keeps tax and expenditure levels in line with the preference of the median voter.

The Leviathan model, on the other hand, describes a government driven to maximize its tax "take" (Oates 1985). In this model, politics are the culprit, not the solution. Politicians use their powers to tax the population and provide distributive benefits, currying favor among potential supporters. As this cycle continues over time, tax levels and government size spiral to increasingly higher levels. Because 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 effects on local fiscal policy decisions. Most of the more recent empirical findings have documented that TELs have been effective in reducing local revenues (especially property-tax revenues) or spending (Preston and Ichniowski 1991; Poterba and Rueben 1995; Dye and McGuire 1997; Shadbegian 1998, 1999). These findings have been cited as prima facie 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 tax-maximizing, citizen exploiters. 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. Similarly, tests of the Tiebout's (1956) model, with its focus on residents shopping among communities, have tended to address the demand side, leaving the supply side of the model—that would tackle political distinctions among local governments—less fully developed (Fischel 2000).

In empirical studies, variations in local service cost, demand, and taste have been accounted for (Preston and Ichniowski 1991). 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). Many have contended that state property-tax limits are meaningful only if they impose a binding cap on levies or on the combination of both tax rates and assessments (see, e.g., Joyce and Mullins 1991). Some analyses include only "potentially binding TELs" (Poterba and Rueben 1995; Shadbegian 1998, 1999). Despite recognizing distinctions in the factors of demand and in the apparent stringency of higher-level rules, the models ignore institutional variations in governance among cities. As a result, these studies cannot consider how city institutions may interact with state rules to produce a different result.

Different incentives emerge for local political actors operating within the shadow of the law. When cities' constitutional-level institutions create high-powered incentives, local fiscal behavior may correspond more closely 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 expectations of the effects of state substantive rules. Specifically, it is anticipated that state-imposed tax limits will have greater effect when imposed on cities that have the mayor-council form of government and lesser effect when imposed on cities that have the council-manager form of government. These expectations are summarized in Table 1.

APPROACH

Two simple models are tested to evaluate the effects of TELs on cities' revenue choices, using pooled cross-sectional time-series data. The first model estimates 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. This population restriction results in a set that includes at least one city from 42 of the 50 states. As a result, the findings are not so much generalizable to other, smaller cities as they are predictive of these larger cities' responses to future state-imposed mandates.

Property-tax reliance was chosen as the dependent variable because of its availability as a revenue source to all cities, its target for state tax restrictions, as well as its importance to citizens, bureaucrats, and politicians. No other revenue source is available to all cities. No other source is so completely local in its levy and administration (Fisher 1996). Perhaps because of its local nature, no other revenue source is targeted specifically by state TELs. 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.[3] 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. For these reasons, property-tax dependence offers a unique vantage point for observing local officials' responses to incentives (created by the form of government) and to the broad categories of state restrictions.

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 Prais-Winsten transformation is employed to produce serially independent errors. 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 are consistent, and the estimation process deals with panel-level heteroscedasticity and contemporaneous spatial autocorrelation.[4]

TABLE 1: Form of Government and Property-Tax Dependence: Expectations

Form	*Incentive Environment*	*Prevailing Values*	*Expected Conditions*	*Response to State-Imposed Tax Limit*
Mayor-council	High-powered	Political: focus on reelection	Higher dependence on discretionary taxes to enhance ability to deliver particularistic benefits	Lower property tax dependence
Council-manager	Low-powered	Professional: focus on efficiency	Lower dependence on discretionary taxes to enhance efficiency and delivery of community-wide benefits	Less influence on property tax dependence

Property-tax reliance is operationalized as the percentage of own-source city revenues derived from property taxes. Each model includes controls for service demand with indicators of population, the population in poverty, the White population, home ownership, and personal income. Each model also incorporates 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 target property taxes (levy limits, rate limits, and assessment-increase limits) for each city-year observation.[5] They are assigned the value of one (1) when the limit is present. Similarly, city income- and sales-tax powers are each measured as one (1) when states have granted the city the authority to access that tax base. Government structure is coded as one (1) to designate the mayor-council form of government and coded zero (0) to designate the council-manager form. State-imposed TELs and tax authority are cast as dichotomous variables to capture basic distinctions among institutions. These operationalizations are consistent with the perspective of the shadow-of-the-law model. In addition to estimating the additive effects of TELs and form of government, multiplicative terms are included to capture the interactions between the mayor-council form of government and the various property-tax restrictions.

Mullins and Cox's (1995) measures of state laws restricting local revenue powers are used for all years up to 1992. These data have been updated by reviewing the annotated statutes of each state, cross-checking these results with data provided by the *Municipal Yearbook* (1975–1992), 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 Advisory Commission on Intergovernmental Relations's (ACIR's) *Fiscal Federalism* series (1976–1995).

City financial and population data were drawn from published and online reports provided by the Census Bureau and various volumes of the *County City Data Book* (U. S. Census Bureau 1977–2000). 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%, 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, the same form was coded for the missing period. This assumes that cities did not adopt a governance structure, repeal it, and 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, data from various ICMA and online resources were used to complete the data based on the most proximate year.[6] Figure 2 depicts the general trends in the key variables of interest from 1975 to 1995.

ANALYSIS

The results reported in Table 2 provide strong confirmation 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 2, 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 large enough to be statistically different from zero (0). When other factors are held constant, state limits on property assessment lower cities' property-

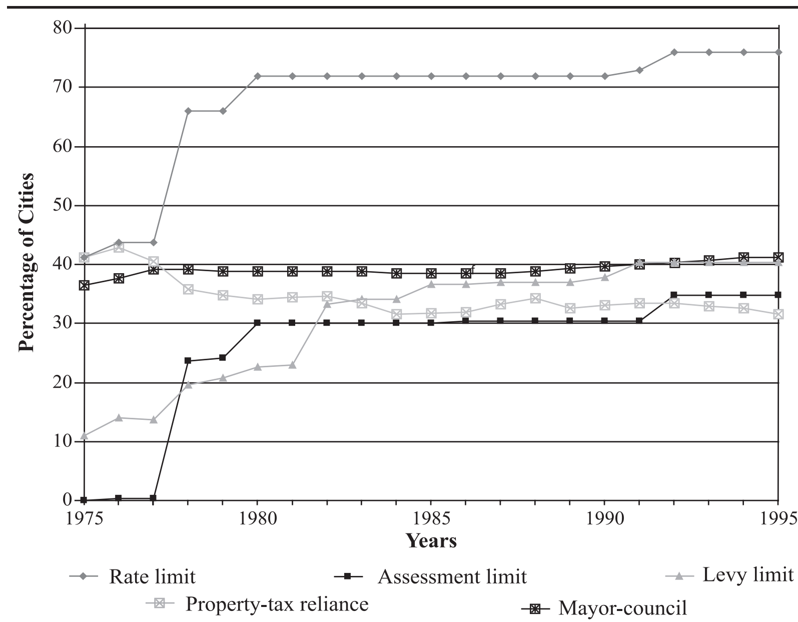

Figure 2: Mean Values of Key Variables

tax reliance by about 7%, on average, whereas levy limits reduce cities' property-tax reliance by 3%.

The results reported in Table 3 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, which is consistent with our theory. In communities without any rate, assessment, or levy limits, cities with the mayor-council form of government obtain a little more than 8% more of their own-source revenues from property taxes than do council-manager cities. Because 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 relying more heavily on the revenue source that gives them the greater amount of discretion.

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

TABLE 2: State Restrictions and City Property-Tax Reliance, 1975–1995

	The Basic Model		
Variable	*Coefficient*	*Standard Error*	t *Score*
Constant	62.427	15.646	3.990
Rate limits	–3.131	2.750	–1.138
Assessment limits	–7.287	2.745	–2.654
Levy limits	–3.154	0.894	–3.530
Controls			
PCPI	–0.000	0.000	–1.287
Poverty	–3.318	1.255	–2.643
Owner-occupied housing	0.141	0.203	0.697
White	0.463	16.551	0.028
Population	0.000	0.000	0.462
Long-term debt	0.000	0.000	0.833
Sales tax	–20.762	2.516	–8.251
Income tax	–21.480	1.749	–12.284

NOTE: PCPI = Per capita personal income. *N* for cities = 267. *N* for observations = 6,443. Wald $\chi^2(12) = 2{,}260.06$. Probability $> \chi^2 = .0000$.

intended to limit cities' fiscal choices. Rate limits reduce property-tax reliance by 10.1% in cities with mayor-council government, a decrease of 7.7% more than in council-manager government. This result sharply contrasts with the traditional finding that rate limits are the weakest of the tax limits (Lowery 1983). The effects of levy limits and mayor-council form of government are not statistically different from zero (0), 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 that transform them into an effective restriction in these cases. Restrictions on assessment increases offer limited incentives to self-interested politicians because property assessment is typically beyond their influence. That is, assessment depends on changes in property values, which often are ascertained by independent assessors. A substantial majority of the states in this study rely on tax assessors that are independently elected or appointed by the county, not the city. In Maryland, the tax assessor is a state office rather than a local one (see International Association of Assessing Officers at http://www.iaao.org). Consistent with the shadow-of-the-law notion, this basic procedural difference matters.

TABLE 3: State Restrictions and City Property-Tax Reliance, 1975–1995

	Institutional Effects Model		
Variable	*Coefficient*	*Standard Error*	t *score*
Constant	58.691	14.975	3.919
Rate limits	-2.368	1.444	-1.640
Assessment limits	-10.657	2.937	-3.629
Levy limits	-4.546	1.425	-3.190
Mayor-council	8.268	1.880	4.399
Both mayor-council and rate limits	-7.698	2.089	-3.685
Both mayor-council and assessment limits	10.902	3.008	3.624
Both mayor-council and levy limits	2.403	1.675	1.435
Controls			
PCPI	0.000	0.000	–1.210
Poverty	–3.701	1.294	–2.861
Owner-occupied housing	–0.006	0.251	–0.025
White	–1.260	15.340	–0.082
Population	–0.000	0.000	–0.822
Long-term debt	0.000	0.000	0.850
Sales tax	–16.080	1.913	–8.405
Income tax	–20.575	1.427	–14.417

NOTE: PCPI = Per capita personal income. *N* for cities = 267. *N* for observations = 6,444. Wald $\chi^2(12) = 3{,}664.14$. Probability $> \chi^2 = .0000$.

Mayor-council cities with assessment limits average an 11% higher reliance on property taxes, holding other factors constant. It may be that assessment limits fail to act as effective restrictions in the high-powered incentive environment of mayor-council cities. Indeed, when property values increase, the independence of the tax assessor allows mayors to reap greater revenues without either increasing the tax rate or taking the blame for raising taxes. Because 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 remote (Lowery 1985). For taxpayers, rate limits seem to offer an understandable change for the better. Perhaps more important for self-interested politicians, a lower tax rate is a benefit that can be delivered to individual voters.

DISCUSSION

Nested institutions, and the shadows they cast, shape the expectations of local actors in predictable ways. Taking the incentive effects of state and local institutions into account helps fine-tune the understanding of intergovernmental relations. Traditionally, the higher-level governments' rules have been expected to act directly on lower-level governments to modify their actions. Indeed, the theory of Leviathan government holds that exogenous rules (such as state limits on city taxes) are the sole hope of restraining the Leviathan's inexorable tendency to exploit citizens (Brennan and Buchanan 1980). Similarly, exogenous rules by a higher-level government have been the usual prescription for halting the overuse of such common pool resources as fisheries and water resources. Absent perfect information, the higher-level government has little hope of setting limits on resource use at the level that will be most beneficial in each community. This suggests that there will be cases in which there is a poor fit between the rule and the resource use. The exogenous-rule doctrine is challenged also by cases in which citizens organize and govern themselves to manage their use of the resource. Ostrom (1990) delineates conditions that allow the citizens depending on a common pool resource to govern themselves to maintain the resource without the deus ex machina of government intervention.

Tax capacity also can be viewed as a common pool resource with the potential for overuse (Berry 2002). From this perspective, state-imposed TELs are the higher-level government's intervention to prevent exploitation of the tax base. As in efforts to control common pool resources, these higher-level-rules will, at times, be set at a level that does not account for individual differences in the resource base or the specific local governing organizations and institutional structures. Our findings—that city institutional structures affect fiscal policy outcomes—call attention to the institutional differences among cities and how those institutions shape both officials' incentives and their responses to mandates. Through their charters, the citizens of cities craft institutions for self-governance. As in the principles behind governing the commons, these rules can be fashioned to reduce the temptation to exploit resources, because the local institutions shape the incentives of public officials. Cities' choice of governance systems may do as much—or more—to keep local tax and spending decisions in line with citizens' preferences.

During 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. 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 ways in which local policies will be made, the constituencies that will be served, and as our findings suggest, state-level preferences are implemented.

NOTES

1. Some states also limit total revenues or expenditures. These restrictions are applied infrequently to cities, and the lack of variation led them to drop out of our statistical analysis. For this reason, revenue and expenditure limits are not discussed here.

2. These studies examined tax and expenditure limits' (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 (Wright 1988). 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. 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.

3. Intergovernmental aid masks the city's costs of services to its citizens. For this reason, property-tax reliance was examined as a share of city own-source revenue.

4. Fixed effects were not employed because unit effects were correlated with forms of government. The Hausman test for fixed effects was not significant at .05.

5. In a few cases, tax limits are not imposed on all cities. For example, New York's limit on assessment increases applies only to jurisdictions with populations of a million or more, which 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 applies only to Rockford, which lost its home-rule status in 1978.

6. Additional information concerning the data and its measurement is available from the authors.

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