
Are Local Government Tax And Expenditure Limitations a Race To The Bottom?

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Prepared By:

Brian Gottlob
PolEcon

Dover, New Hampshire 03820
(603) 749-4072

bgottlob@poleconresearch.com



polecon research

Are Local Government Tax and Expenditure Limitations A “Race To The Bottom?”

Measures to limit local government expenditures or taxes have become widespread in the United States over the last two decades and such limitations are now being aggressively debated in New Hampshire where a number of communities, most prominently Manchester, have or will soon hold referenda on measures to cap local expenditures and taxes.

The embrace of expenditure and tax limitations by local governments raises a number of questions. How have such restrictions affected local public finances? On balance, have tax and expenditure limits had desirable or undesirable fiscal, economic, demographic, and social effects on the communities? How are the impacts distributed across local programs and services? These are important questions for communities and residents contemplating enacting tax or expenditure caps. To date, several communities in New Hampshire (Franklin, Derry, Nashua, Laconia, and most recently Dover and Rochester) have adopted tax or expenditure limitations but only one, Franklin, has a long enough history with an expenditure limitation to adequately assess the full range of impacts.

Franklin is prominently cited by advocates as evidence of a successful implementation of an expenditure limitation. It is thus appropriate to look for evidence of how the expenditures of the City of Franklin may differ from those of communities without a cap. It is also important to examine how the pattern of expenditures in Franklin has influenced local economic, demographic and socioeconomic trends in the community. Empirical research nationally has generally found that expenditure and tax limitations result in lower expenditures and expenditure growth than in comparable communities without caps. But research also indicates that local expenditure limits produce a number of other unanticipated effects.

Research nationally, as well as our comparison of NH communities, finds that tax and expenditure caps are likely to have much broader impacts on communities than simply reducing local expenditures. This study documents the fiscal, economic, and demographic impacts of the spending cap in Franklin and compares trends in Franklin with that of other New Hampshire communities. We specifically highlight trends in the City of Manchester in comparison to Franklin, because as New Hampshire’s largest city, the decision Manchester makes regarding any spending or tax cap is likely to have impacts that extend beyond the City, to affect surrounding communities and the State of New Hampshire as a whole.

The expenditure cap in place in Franklin for nearly two decades has clearly resulted in lower levels of local government expenditures than comparable communities in New Hampshire. As this report documents, the lower level of property tax supported spending in Franklin is largely the result of lower spending on education, in part, because Franklin receives more state education aid per pupil than almost any other city in NH except Berlin. Unfortunately, Franklin’s higher level of state education aid and associated lower level of local education spending is as much a sign of economic and demographic weakness as it is of the success of the city’s expenditure cap.

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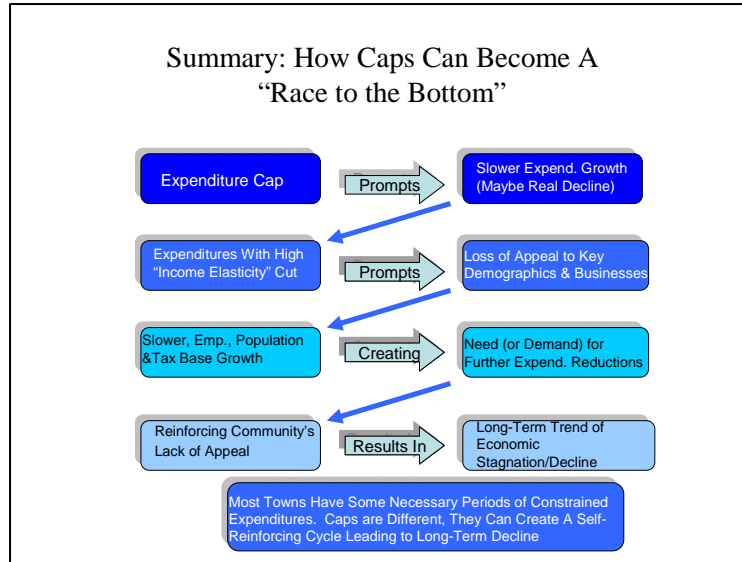
Although it is being touted (and emulated) as a successful expenditure cap community, our analysis shows that, by almost any economic or demographic measure, the City of Franklin lags nearly all other cities in New Hampshire. In contrast, the City of Manchester has experienced more favorable economic and demographic trends with relatively little difference between it and Franklin on key measures of expenditures and taxes. This is an important conclusion for communities considering a tax or expenditure cap. It is a conclusion that will be carefully scrutinized and likely disputed. Although the findings and conclusions in this report will likely be viewed and interpreted by readers through an ideological lens, the evidence and conclusions are presented without regard to any ideological or political bias.

The merits of tax and expenditure caps are most often debated on political and ideological grounds, but the reaction to caps by individuals, families, and businesses and their actions over a significant period of time provide the only empirical basis for evaluating the overall impacts of such limitations. On the basis of employment and business growth, growth in commercial and industrial property valuations, population growth and the addition of a skilled, well educated workforce, the City of Franklin performs much worse than the City of Manchester and nearly all comparable communities in NH. Ironically, the relatively weaker economy of Franklin has resulted in slower growth in non-residential property in the City of Franklin and despite relatively slower growth in expenditures, has produced a greater shifting of the total property tax burden onto residential property than has occurred in nearly all other cities in NH.

We have chosen to characterize the apparent impacts of expenditure limitations as a potential 'race to the bottom.' A race to bottom can occur when tax caps impact services with a higher income elasticity (those that are more likely in demand the higher up the income scale you go) - such things as schools, libraries, cultural and civic amenities, as well as many activities that require capital expenditures (bonding). These expenditures are also those that can make a more attractive community for many individuals, families and businesses, especially residents with higher occupational skill levels and higher levels of educational attainment. Growing businesses value these workers, or the opportunity to sell goods and services to them, and often choose to locate in communities that can attract skilled and better educated individuals and households. As towns become less attractive to some demographic groups and families, they also become less attractive to businesses who may also find that tax cap communities offer fewer of the individuals and services they require or value. Because businesses can find cap towns less attractive, the non-residential tax base may grow more slowly, placing even more pressure on residential property even as expenditures are kept low by the cap. This may result in even more pressure to constrain spending on services, further reinforcing the trend of demographic and economic stagnation (or decline) in cap towns. In addition, cap towns become more homogenous, as residents who value services and amenities that do not survive the cap increasingly avoid or leave cap towns, while those who remain tend to be most supportive of a cap.

The end result is a downward spiraling, self-reinforcing cycle (or "race to the bottom") where demographic groups and businesses that could place towns on more

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positive economic and demographic trends increasingly avoid cap towns in favor of towns that are more likely to provide the mix of services desired by individuals and businesses. A corollary is that changes in demographics (increase in higher income and well educated residents) and increases in business and employment growth may also create an increased demand for the services (and expenditures) valued by these constituencies that may initially add to pressures to limit expenditures. This was clearly the case in Dover, and to a lesser extent Somersworth where changing demographics and an expanding economy created increased service demands¹. But it is also true in Manchester where a growing technology and higher-end service based economy has attracted more individuals with higher skills and levels of educational attainment, as well as the businesses that hire or market to them, and along with them greater expectations of the City from both individuals and businesses in terms of cultural, civic, and social amenities as well as key local government services.

There is no "correct" level of local government expenditures. Communities that provide a mix of services that match the preferences of their residents should not be criticized and it is not the purpose of this report to advocate for more or fewer expenditures by local government, or to argue for or against expenditure or tax caps. Our purpose is to go beyond ideological arguments and to increase the information available to communities considering the adoption of caps. Individuals and families generally sort themselves among communities in order to find the best match between their preferences for local services, the services offered by a community, and the price of residing in a community. This report documents some of the evidence of the longer-term, broad implications that result as families and business make location decisions in response to tax and expenditure limitations. Our results suggest that tax and expenditure caps can have significant negative effects on demographic and economic trends of a community.

¹ Momentum for Dover's expenditure cap was also influenced by highly publicized retirement and severance payments that were widely seen as unfair or even abusive.

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Key Findings Include:

Expenditure and Tax Impacts

- ◆ National research shows that expenditure and tax caps generally result in lower levels of expenditures in communities that enact them. This is supported by the experience of the City of Franklin, where the total per capita local property tax burden is the lowest among all NH communities with at least 8,000 residents. But several communities, including Manchester, contemplating tax and expenditure caps already have among the lowest per capita tax burdens in the state (Figure 1).

Franklin's Per Capita Taxes are the Lowest in the State for Towns With at Least 8,000 Residents, While Several Towns Contemplating Expenditure Caps (Including Manchester) . Already Have Among the Lowest Tax Burdens Per Capita

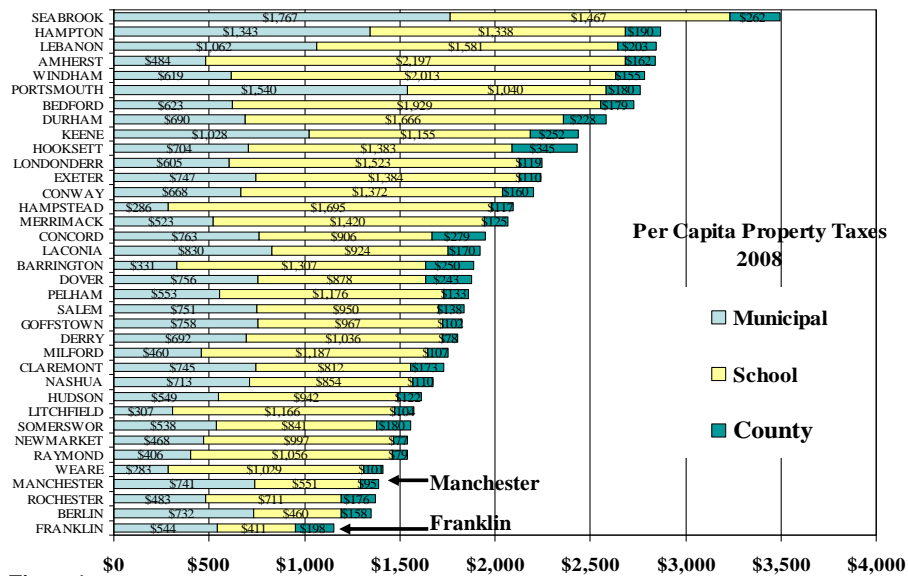


Figure 1

- ◆ Because more of Manchester's property taxes are paid by commercial, industrial, and utility property owners, the per capita property tax impact of the city's expenditures on home and residential property owners is actually slightly lower in Manchester than in Franklin (Figure 2.)

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Local Property Taxes Per Capita are Lower in Franklin than in Most NH Towns, But the Amount Paid by Residential Property Owners is Actually Lower in Manchester Because of Manchester's Higher Portion of Non-Residential Property

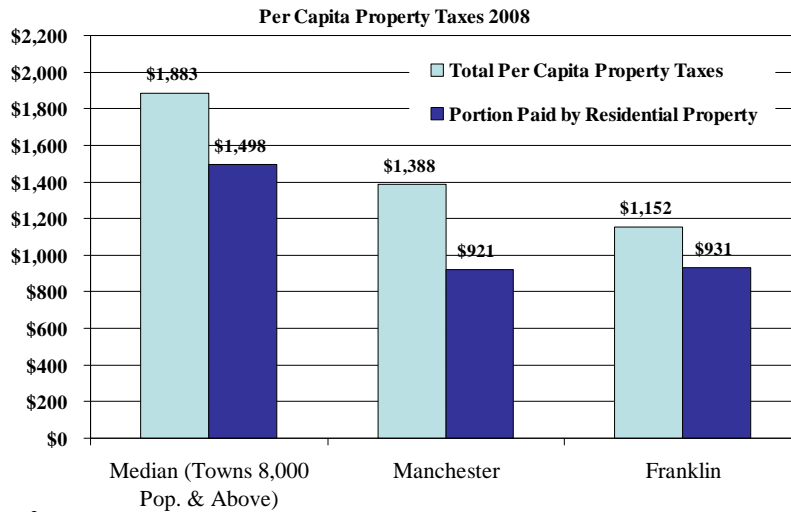


Figure 2

- ◆ In most towns contemplating tax caps, relatively higher percentages of commercial and industrial property in the tax base results in the per capita tax burden that falls on homeowners and residential property being lower than in towns with caps (Figure 3). Concord, Somersworth, Manchester and Rochester (before it adopted a cap) all have per capita property tax burdens that fall on homeowners that are lower than the cap communities of Laconia, Derry, and Nashua. Manchester's residential per capita tax burden is lower than all communities (including Franklin) except Berlin. Further analysis (discussed in following sections of this report) indicates that the commercial and industrial property tax base has grown more slowly in tax and expenditure cap communities. One result is that while property tax collections may grow more slowly in cap communities, more of the tax burden shifts to residential property.

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Because Most Towns Contemplating Tax Caps (Including Manchester) Have a Higher % of Their Tax Base in Commercial, Industrial, and Utility Property, the Amount of Property Taxes That Actually Falls on Residential Property is Lower Than in Some Towns With Caps

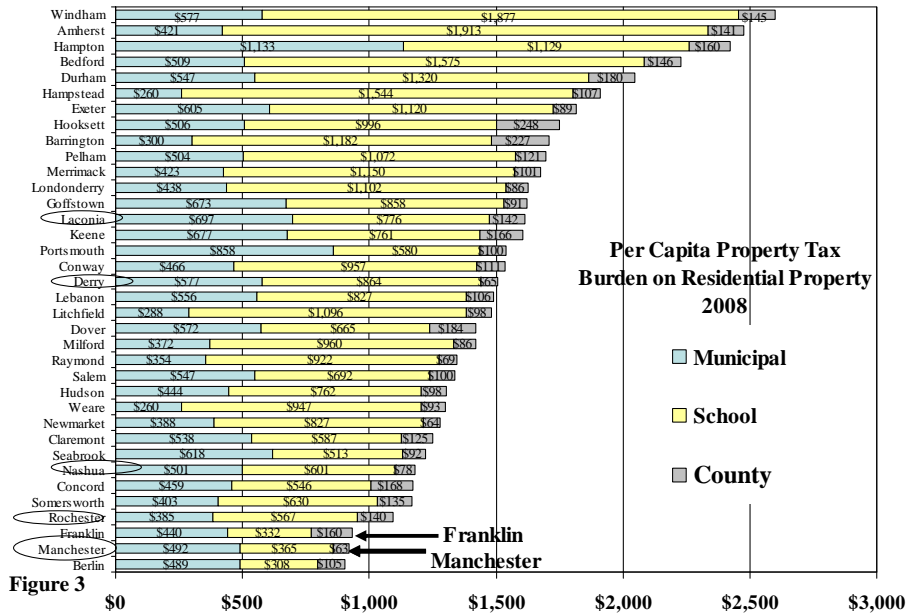


Figure 3

- ◆ Public safety expenditures (police, fire and rescue) appear relatively less affected by expenditure caps, while expenditures for schools, streets and roads, libraries, capital projects and improvements (debt service) and other services that increase the amenities and attractiveness of a community are lower than the NH median (Figure 4.) The implication is that longer term investments in maintenance, repair, and facilities as well as services with a

Investments in Infrastructure, Capital Expenditures, Schools and Libraries are Most Affected by Caps (In NH and Research Nationally.) But Focusing only on “Essentials” May Undermine Long-Term Economic & Demographic Viability

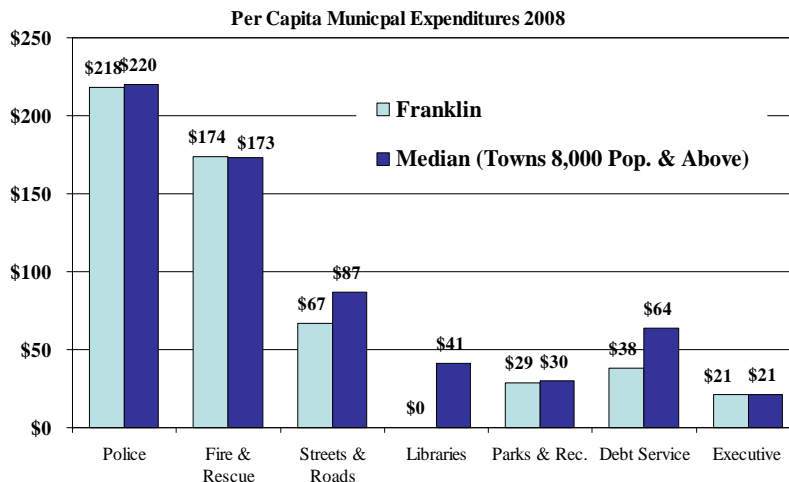


Figure 4

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higher income elasticity (greater demand as income level increases), absorb most of the impact of tax and expenditure caps.

- ◆ Manchester’s per capita expenditures are, in general, comparable or lower than Franklin’s. The most significant difference is in Manchester’s debt service that includes payments for facilities such as the airport, Verizon Center, and MerchantAuto.com baseball stadium (Figure 5). Each of these capital expenditures also generates revenue that service some portion of the debt. These civic, cultural, and economic facilities, and the debt service associated with them, are characteristically found in important metropolitan areas that are centers of regional economic activity. How a tax or expenditure cap would affected the ability of a city to develop these types of facilities is unclear and an important issue to consider. What is clear is that these facilities have increased the city’s amenities and attractiveness to a broader range of individuals and businesses.

Manchester’s Per Capita Expenditures on Many Key Municipal Services are at or Near Levels of Franklin – Debt Service is the Largest Difference.

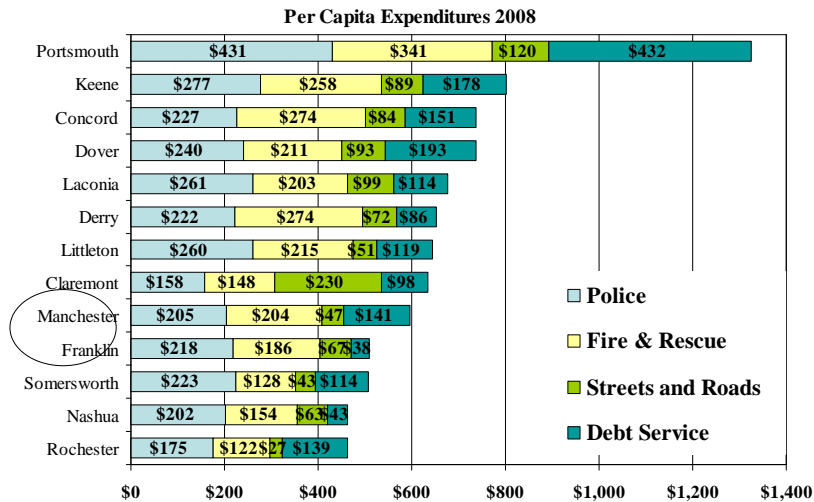


Figure 5

- ◆ Lower school spending appears to account for the largest share of lower expenditures in Franklin (Figure 6), and research in other states suggest that this is a characteristic of tax caps across the county.

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The Local Property Tax Commitment of Franklin is Lower than for Most NH Cities, Especially for Schools (In Part Because of Higher State Aid, but Also Lower Levels of Support)

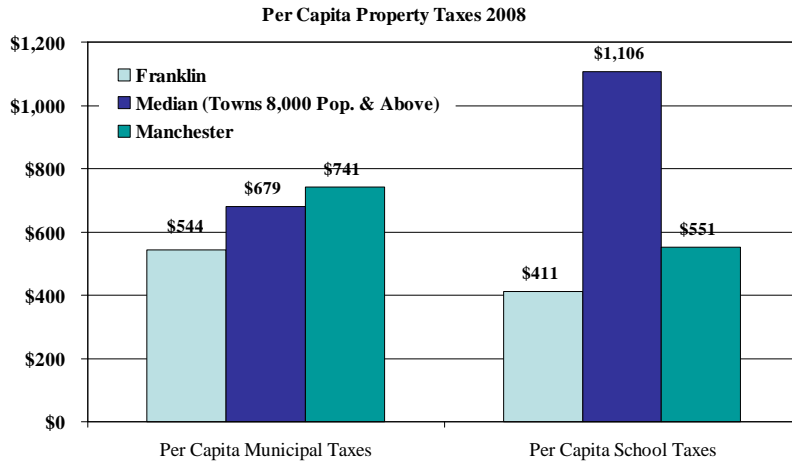


Figure 6

- ◆ Communities without expenditure or tax caps can control expenditures as well as capped communities. Several communities without tax caps had per capita municipal expenditure growth (not schools²) similar or lower than Franklin's between 2000 and 2008. Manchester's per capita municipal growth was well below the median for communities with at least 8,000 residents.

Several NH Communities Had Lower Per Capita Municipal Expenditure Growth this Decade Than has Franklin. Manchester's Growth is Below the Median of 50.3%

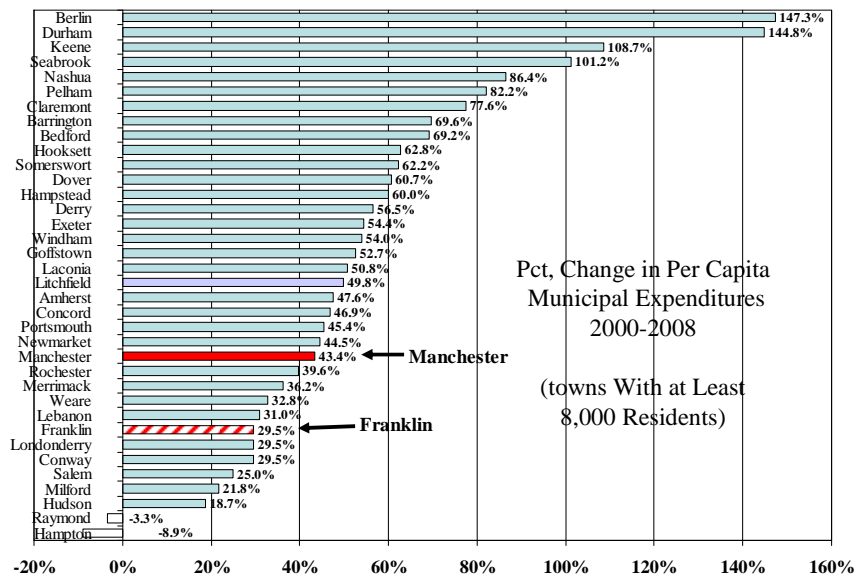


Figure 7

² Schools are not included here because changes in state aid have significantly affected local school taxes.

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- ◆ Slow growth in the commercial and industrial property base of Franklin has shifted a greater share of the property tax burden onto residential property owners even as expenditures have grown more slowly in the City than in most other communities. Manchester’s greater increase in the commercial and industrial tax base this decade means that growth in per capita property taxes paid by residential property owners has grown at about the same rate in Manchester as in Franklin this decade (Figure 8).

Because the Value of Non-Residential Property Has Grown Much Faster in Manchester, Property Taxes Paid by Residential Property Owners Have Grown at Nearly the Same Rate in Manchester and Franklin This Decade

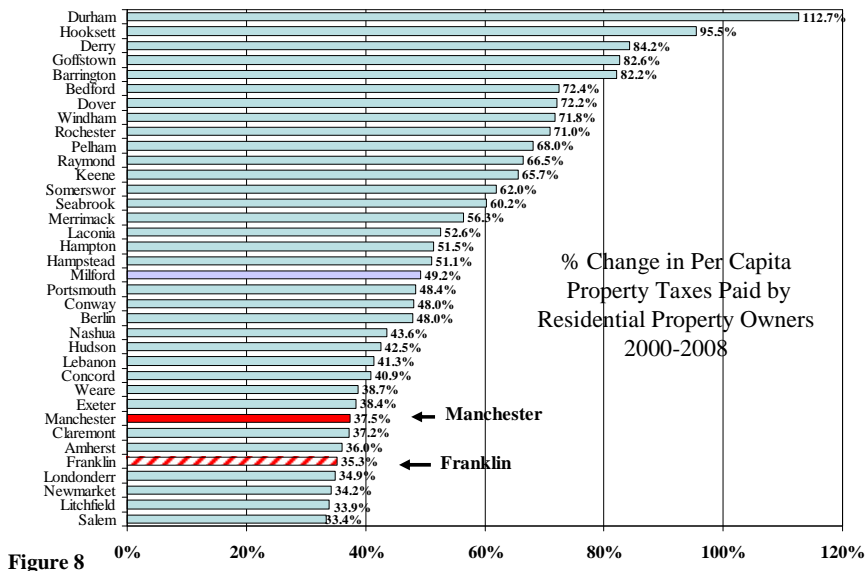


Figure 8

- ◆ Despite receiving more state education aid per student than all but six towns (as a result of relatively weaker economic and demographic trends that produce a smaller tax base), Franklin still spends less on each student in its schools than all but 3 communities (Figure 9). Most of the lower property tax collections in Franklin are related to lower spending on schools, with municipal spending on streets and roads, libraries, and capital investments in buildings and infrastructure also accounting for a significant portion of the City’s lower expenditures.

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Education Bears the Brunt of Caps: Only Six Towns Received More than Franklin's \$5,341 in State Aid Per Pupil, but the City Still Spent Less Per Pupil Than all But 3 Communities
(One Implication: Even More Non-Local Dollars for Schools Won't Boost Expenditures Much)

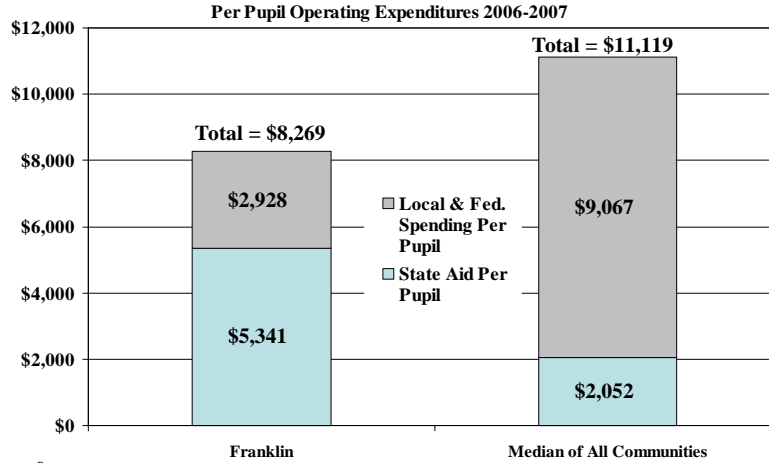


Figure 9

- ◆ Because the Consumer Price Index does not accurately measure trends in the cost of providing government services (state and local service costs have risen more rapidly this decade), capping spending on the basis of the CPI can effectively result in cuts to real (inflation adjusted) expenditures. Because towns with caps appear to grow more slowly, with slower growth in their tax bases, using a CPI-based cap will produce larger, real, expenditure cuts than intended (Figure 10.)

Because the Consumer Price Index Has Not Been A Good Recent Indicator of the Price Increases Faced by State and Local Governments, Real (Inflation Adjusted) Allowed Spending Will be Reduced More Than Intended

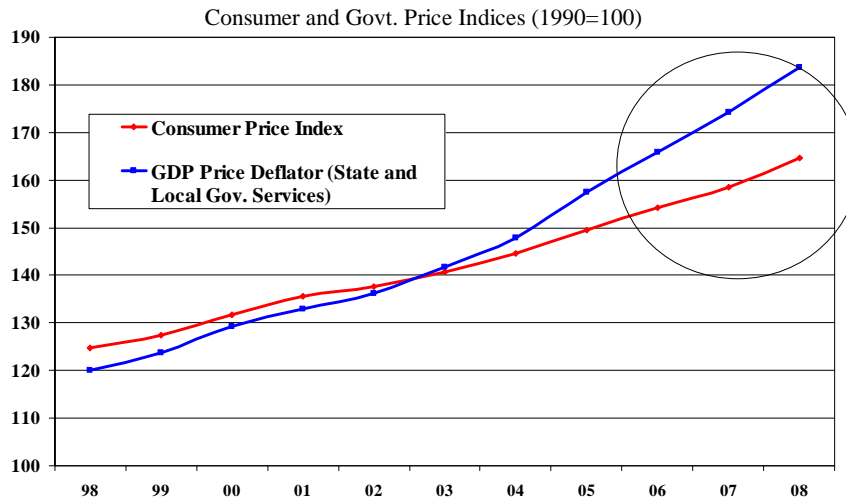


Figure 10

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Demographic Impacts

- ◆ Where people choose to move or locate is the best objective measure of the appeal of a community. Since the Franklin tax cap was enacted, population growth in the City has grown more slowly than all but 3 (including Berlin, and Claremont) of the state's 40 largest communities.³ In general, larger cities do not experience rapid population growth and smaller communities are more likely to experience substantial growth or decline. Many of NH's smaller, suburban and "bedroom" communities experienced rapid growth over the past two decades. Nevertheless, Manchester's population grew at more than twice the rate of Franklin's since 1990. Median population growth for the 40 communities was 18.7% between 1990 and 2007, compared to just 4.1% in Franklin and 9.1% in Manchester (Figure 11). Although rapid growth can create problems, the financial and economic impacts of stagnating or declining populations create much more problematic fiscal and economic conditions, as evidenced by cities such as Berlin.

Franklin's Tax Cap Hasn't Made it More Attractive to Individuals and Families
(But Growth in Other Towns Has Increased Service Demands and Cost Pressures)

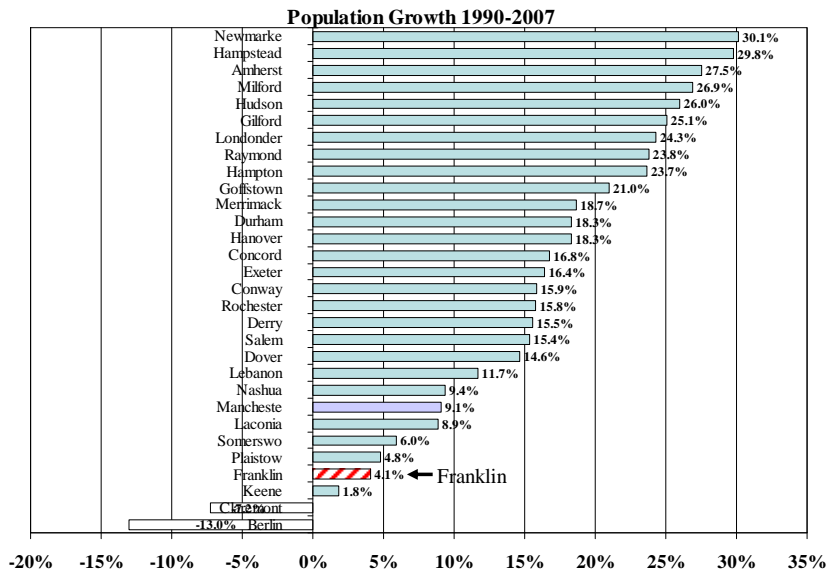


Figure 11

- ◆ Towns with caps, and with lower levels of expenditures on services with a higher income elasticity (e.g. schools, cultural and civic amenities) appear to be less attractive to skilled individuals with higher levels of educational attainment as evidenced by smaller increases in the percentage of their population with a bachelor's degree or higher between 1990 and 2000 (Figure 12.) This trend has significant implications for a community's ability to

³ Portsmouth had negative population growth during that time but the decline was due to the closure of the Pease Air Force base and the related loss of service men and women and their families.

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capture or keep employment in “newer economy” industries. Manchester’s ability to renew its industrial base and to provide real economic opportunities to residents is directly related to its ability to attract skilled and well educated individuals. Individuals with higher levels of educational attainment and skill levels help make an economy dynamic and capable of adaptation and renewal. They have more employment and economic opportunities; they are among the most mobile members of the population and have more locational choices.

Caps Can Reduce Amenities and Services That Appeal to Higher Skilled Individuals
With Higher Levels of Educational Attainment – Making a Community Less
Appealing to Many Businesses in the Process

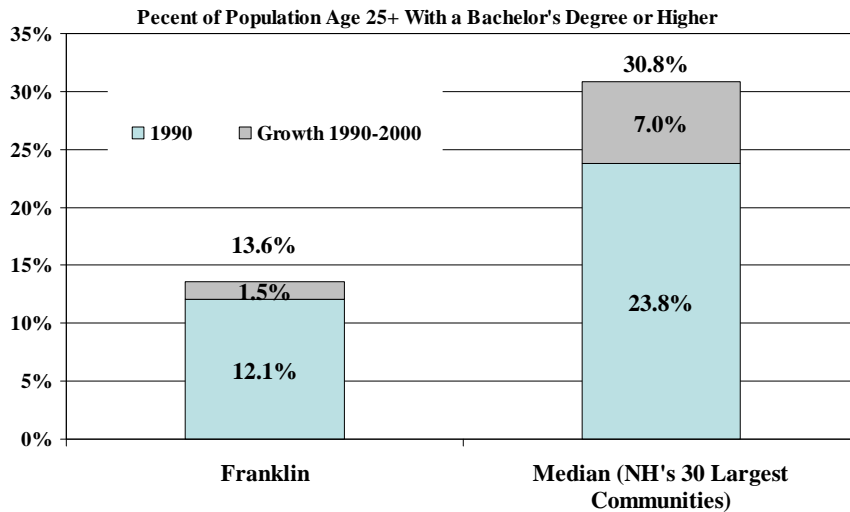


Figure 12

- ◆ Manchester’s future depends on its ability to attract “talent” in the form of educated and skilled residents. Higher amenity cities are more likely to attract talent while lower amenity cities face demographic and economic decline. Some of the key amenities that attract talent are:
 - Aesthetic physical (built) attributes and public spaces that make cities more attractive.
 - Good public services – safe streets, good schools etc.
 - Rich mixture of services and consumer goods.
 - Cultural and social amenities, restaurants, live performances etc.
 - Opportunities for social interactions, and diverse interactions.
 - Speed – the ability to connect to people, places, work and to information, goods and services quickly (physically via transportation and digitally via telecommunications).

- ◆ A corollary of the above trends is that towns with increases in well educated residents are also likely to see increased demands for local amenities and services along with the positive demographic and economic trends.

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- ◆ Because of their impact on economic and demographic trends, tax and expenditure caps produce greater separation of families and businesses along socioeconomic lines. Increasingly dividing them into “have” and “have not” communities.

Economic Impacts

- ◆ Total private sector employment in the City of Franklin declined by 25% between 1999 and 2007. Measuring growth over any time periods between 1990 and 2007, private sector job growth in Franklin is worse than nearly all comparable cities in NH (Figure 13.)

Expenditure Caps Don't Guarantee Stronger Local Economies. Employers Value Town Services and Communities that can Attract Individuals With Higher Levels of Ed. Attainment and More Skills

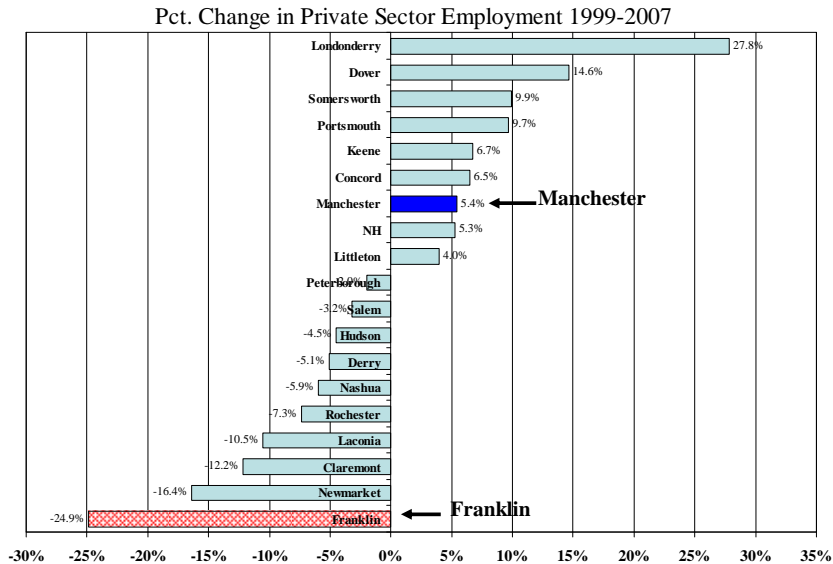


Figure 13

- ◆ Along with employment trends, growth in taxable commercial and industrial property is the best indicator of the desirability of a community to businesses and industry. Growth in the commercial and industrial tax base was lower in Franklin than in a majority of comparable communities this decade. Communities with among the highest and lowest per capita local government expenditures had high rates of growth, suggesting that low levels of local expenditures do not ensure economic growth and that businesses also value community amenities and services (Figure 14).

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The Cap Hasn't Made Franklin More Attractive to Businesses – Franklin Has Had Among the Smallest Increases in the Non-Residential Property Tax Base, Manchester Has Had Among the Largest

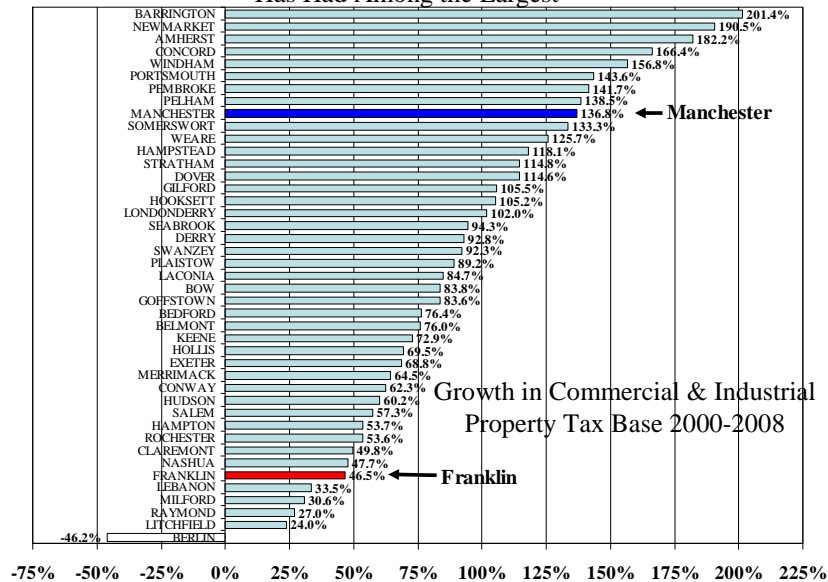


Figure 14

- ◆ It will take years to accurately assess the impact of tax and expenditure caps in communities that have enacted them in recent years but employment and property tax base growth trends suggest that Franklin’s nearly two-decade old expenditure cap has not made the City relatively more attractive to businesses, compared to non-capped communities. Despite slower population growth, on a per capita basis, the residential property tax base grew much faster than did the taxable commercial and industrial property base in Franklin, resulting in the fifth largest shift of property tax burden from commercial and industrial property owners to residential property owners, among NH’s largest communities (Figure 15). Because the higher residential tax base was not the result of increased population and housing units, and was not accompanied by a concomitant increase in commercial and industrial property, a larger share of the overall tax burden was placed on existing residential taxpayers.

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Rapid Increases in Home Values in the First Half of the Decade Helped Increase the Percentage of the Property Tax Base that is Residential, But Franklin's Slow Growth in its Commercial & Industrial Tax Base Has Produced a Larger Shift of Tax Burdens to Residential Property Owners

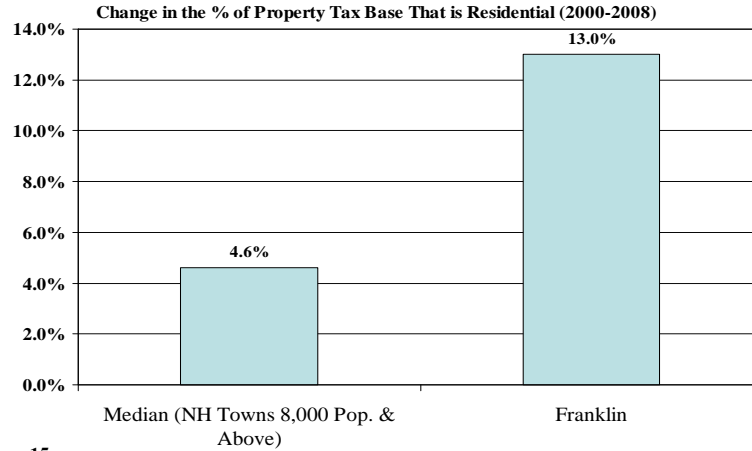


Figure 15

- ◆ Rapid home price appreciation during the first half of this decade has resulted in the residential property tax base of most communities rising faster than has their commercial and industrial tax base. The process of shifting tax burdens to residential property was accelerated in communities that were relatively less attractive to businesses, and where the commercial industrial tax base grew the least. When expenditure caps make a community less attractive to businesses and key demographic groups, they slow the growth in the commercial and industrial tax base that result in more stringent expenditure limits. When expenditures controls limit the ability of a community to provide the mix of services and amenities that businesses and individuals value, a community sees further reductions in economic and demographic growth that results in slower tax base growth and a self-reinforcing cycle or “race to the bottom” can be the result.

Overall these trends suggest that any benefits residents of the City of Franklin receive from their expenditure cap are mitigated by the fact that individuals, families, and businesses appear to view the community as a less desirable place to locate than alternative communities. The long-term implications (and we now have evidence from two decades) are a relative erosion (compared to other communities) of the demographic and economic base of the City.

By most objective measures, the City of Manchester has been able to keep growth in the overall property tax burden at a level similar to the tax cap City of Franklin. Manchester has done so at the same time it has increased civic, cultural, and recreational amenities that make the city relatively more attractive for businesses investment, individuals, and families who are the key to the long-term economic and demographic prosperity of the City.

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Research nationally, and supported by the findings of this report, shows that communities which offer services valued by individuals, families, and businesses at a reasonable price are more likely to have growing economies and populations. In contrast, communities that simply look to keep taxes and the tax price of services low, without providing the services or service quality valued by individuals and businesses are much less likely to prosper.

In today's economic environment few will argue against the need for fiscal prudence and discipline. At the same time, decades of economic and demographic data in New Hampshire and nationwide show how important it is for communities to provide services valued by individuals and businesses. These two seemingly contradictory objectives can only be reconciled with the concept of "value." Communities that provide a high level of services that are important to residents and businesses at a reasonable price provide "value" to residents for the tax dollars they pay. These communities will have the most appeal to businesses and individuals. But value is not simply low price, but rather a combination of quality of a good or service and its price. The key question for communities considering tax or expenditure caps is whether these caps are more or less likely to provide value to taxpayers. The evidence nationally, as well as that examined in New Hampshire suggests that tax and expenditure caps can reduce expenditures but may come at a high economic and demographic cost to towns. Caps appear to be a far too blunt instrument to use in achieving a balance in important fiscal and economic goals.