



# The Essential Role of Fiscal Authority in Local Democracy

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## The Local Solutions Support Center White Paper Series

In recent years, state lawmakers have become more aggressive in interfering with local lawmaking through their use of “preemption” –stopping local governments from passing laws and invalidating local laws that have already been enacted. Used sparingly and properly, preemption can serve the common good, by imposing minimum statewide standards and adopting uniform state policies. Unfortunately, preemption is now being used to stop local innovations across a broad and growing range of issues, including labor standards, environmental protection, civil rights, broadband access, fracking, public health, and gun safety. This misuse of state preemption power perpetuates racial and economic inequality, limits local anti-discrimination efforts, and systemically strips local governments of their power to set standards that reflect the views and values of their citizens.

To detail the effects of these abuses of state power, the Local Solutions Support Center, a hub that works to track, coordinate and create opportunities to protect local progress, is publishing a series of white papers written by local governance experts designed to explain the current threats facing local democracies.

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## Introduction: Fiscal Authority Is Critical for Local Democracy

Local governments provide many of the most basic public services that communities need, including police and fire protection, in addition to important public goods like parks and libraries. Local governments are also policy leaders: cities and counties have been at the forefront of myriad recent policy innovations, from the Fight for \$15 to LGBTQ-inclusive nondiscrimination to plastic bag bans and more. To take the most recent example, local governments are playing a critical role in the public health response to COVID-19 and in efforts to provide welfare to those whose livelihoods have been threatened by the pandemic.

In providing these critical services, local governments are more than just administrative agents of the state. They also constitute their own centers of democratic activity. Local rule allows for *local* officials to respond to *local* concerns, and it allows for local officials to take into account local conditions, even in response to problems that may also require state and federal coordination.

While states have traditionally provided significant funding for local governments to accomplish the many tasks allotted to them, they have moved away from giving local governments either funding or the authority to raise revenue themselves. Intergovernmental aid—money flowing from states to local governments—shrank dramatically during the Great Recession, and states have been slow to restore these to pre-recession funding levels, if they have at all. And more recent state-level policy decisions have further undermined local fiscal capacity by curtailing other sources of local government revenue. Further undermining local fiscal capacity, the 2017 federal tax legislation (commonly known as the Tax Cuts and Jobs Act of 2017) capped the state and local tax deduction to \$10,000, raising the cost of local property taxes significantly for many residents.<sup>1</sup>

Chief Justice Marshall famously wrote that “the power to tax involves the power to destroy.”<sup>2</sup> In many cases, the converse is also true: without the power to tax, local governments cannot function. In part as a result of the state and federal policies described above, local governments across the country are currently facing significant fiscal challenges. Moreover, those policies limiting state fiscal authority are not only an economic problem for local governments; they also create a democracy deficit by undermining democratic accountability. When local voters are unhappy with the fiscal decisions of their elected officials, they naturally seek to hold them accountable, but it can be difficult for voters to understand the role the state plays in local budgeting decisions.

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<sup>1</sup> 26 U.S.C. § 164(b)(6)(B)

<sup>2</sup> *M'Culloch v. State*, 17 U.S. 316, 431 (1819).

This White Paper considers the consequences of decreasing state aid to cities, provides an overview of the recent trend of state preemption policies that have further limited local fiscal authority, and offers some suggestions for policies that would allow municipalities to better carry out their important responsibilities as engines of local democracy.

## State Laws Restricting Local Fiscal Authority: An Old Story and An Ongoing Threat

### *State and Federal Aid to Local Governments Has Been Shrinking for Years*

In thinking about local fiscal authority, it is important to state at the outset that localities exist in a federalism landscape of interdependence with state and federal authorities. On average, state aid represents about a third of local government revenues.<sup>3</sup> This average, however, masks important differences between types of local governments (and of course between states).<sup>4</sup> For example, municipalities and townships are less reliant on state aid than local school districts. On average, school districts receive 47% of their funding from the state,<sup>5</sup> while state transfers account for 20% percent of city budgets.<sup>6</sup> Levels of independent fiscal authority often reflect these differences in state aid, with cities likely to have authority to impose more types of taxes than school districts.

Despite these intra-state variations, states across the country shared a common response to their budget problems during the Great Recession. Facing dramatic budget shortfalls, they made deep cuts in intergovernmental aid.<sup>7</sup> While such cuts are typical during recessions, that round of state budget cuts was noticeable not only for the size of the cuts but also for their duration. In fact, some local governments continued to see declines in state support well into the economic recovery. A report examining the fiscal health of America's largest cities found a decline in state and federal aid to 21 of the 29 largest metro areas from 2012 to 2013, a full five years after the crisis hit.<sup>8</sup>

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<sup>3</sup> Nat'l Council of State Legislatures, *State Aid to Local Governments*, <https://www.ncsl.org/research/fiscal-policy/state-aid-to-local-government-update.aspx> (last visited Mar. 31, 2020).

<sup>4</sup> *Id.*

<sup>5</sup> Michael Leachman, Kathleen Masterson & Eric Figueroa, *A Punishing Decade for School Funding*, Center on Budget and Policy Priorities (Nov. 29, 2017), <https://www.cbpp.org/research/state-budget-and-tax/a-punishing-decade-for-school-funding>.

<sup>6</sup> David E. Wildasin, *Intergovernmental Transfers to Local Governments*, in Lincoln Inst. of Land and Policy, *Municipal Revenues and Land Policies* 55 (Gregory K. Ingram & Yu-Hung Hong eds., 2010).

<sup>7</sup> Pew Charitable Trusts American Cities Project, *The Local Squeeze: Falling Revenues and Growing Demand for Services Challenge Cities, Counties, and School Districts* 5–8 (2012), [https://www.pewtrusts.org/-/media/assets/2012/06/pew\\_cities\\_local-squeeze\\_report.pdf](https://www.pewtrusts.org/-/media/assets/2012/06/pew_cities_local-squeeze_report.pdf).

<sup>8</sup> Pew Charitable Trusts, Brief: *Fiscal Health of Large U.S. Cities Varied Long After Great Recession's End* 3 (2016), <https://www.pewtrusts.org/-/media/assets/2016/04/fiscalhealthoflargeuscitiesvariedlongaftergreatrecessionsend.pdf>.

Cyclical cuts to other state programs placed additional pressure on local governments because of their role as “service provider of last resort.”<sup>9</sup> As Andrew Reschovsky observed in the context of an earlier recession, “[r]eductions in state funded human services, not only create hardships for individuals, but often have direct and indirect fiscal implications for the communities in which they live. Thus, cuts in state spending may well result in an implicit shifting of costs from the state to local governments.”<sup>10</sup>

Meanwhile, the federal government has been steadily reducing its direct grants to local governments over the past several decades.<sup>11</sup> Charts sometimes show an increase in federal intergovernmental aid in recent years, but this data does not disaggregate aid flowing to states and aid flowing to the local governments directly. While overall aid has increased, in part due to the significant increase in federal Medicaid funding, local governments have not been made whole from the decline in direct funding.<sup>12</sup> Federal direct support for local governments is a much smaller percentage of local revenue, about 5% of a city’s revenue in 2012.<sup>13</sup> But every dollar counts. As discussed below, local governments face significant legal constraints in raising own-source tax revenue.

### ***The Effect of Shrinking Intergovernmental Aid on Local Governments***

Reductions in intergovernmental aid present local governments with difficult budget choices. Because they lack significant fiscal authority, local governments cannot easily respond to a loss in intergovernmental transfers. Generally speaking, state law restricts municipal authority over fiscal affairs more than it does in other policy areas.<sup>14</sup> One leading survey of municipal home rule suggests that only twelve states provide local governments with fiscal authority, but in five states that authority was limited.<sup>15</sup>

Beyond home rule, other state constitutional provisions also restrict local budget choices. In many states, local governments face significant constitutional restrictions on the ability to raise revenue via property taxes. These restrictions take a variety of forms: some states limit property tax assessment or rate increases, while others limit property tax revenue increases directly through levy limits.<sup>16</sup> States also impose full disclosure or

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<sup>9</sup> Andrew Reschovsky, *The Implication of State Fiscal Stress for Local Governments* (2003), <https://www.urban.org/sites/default/files/publication/58811/1000612-The-Implications-of-State-Fiscal-Stress-for-Local-Governments.pdf>.

<sup>10</sup> *Id.*

<sup>11</sup> Megan Randall, et al., *Follow the Money: How to Track Federal Funding to Local Governments* 13 (2018), [https://www.urban.org/research/publication/follow-money-how-track-federal-funding-local-governments/view/full\\_report](https://www.urban.org/research/publication/follow-money-how-track-federal-funding-local-governments/view/full_report).

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

<sup>14</sup> *Home Rule in America: A Fifty-State Handbook* 2 (Dale Krane, et al, eds., 2001) 476–77 tbl.A1 (categorizing powers states grant under home rule).

<sup>15</sup> *Id.* (listing extent of fiscal home rule authority in each state).

<sup>16</sup> See *Tax Limits*, Lincoln Institute of Land, <https://www.lincolnst.edu/research-data/data-toolkits/significant-features-property-tax/access-property-tax-database/property-tax-limits>. *Id.* See also Glossary, *Significant Features of the Property Tax*. Lincoln Institute of Land Policy and George

truth-in-taxation requirements, which require local governments to disclose tax changes in public hearings,<sup>17</sup> or revenue limits, which limit revenue growth from all sources, and expenditure limits, which limit growth in local spending.<sup>18</sup> Such restrictions have undermined local control over the tax base on which local governments traditionally rely.<sup>19</sup>

Many states also impose political process requirements on jurisdictions seeking to increase tax revenue. Perhaps the best known of these taxing restrictions is California's Proposition 13, which requires supermajority approval from voters to increase local non-property taxes and special assessments.<sup>20</sup> All told, fifteen states have supermajority requirements,<sup>21</sup> and an additional three states require voter approval for tax increases.<sup>22</sup>

These restrictions on local fiscal authority, of course, ignore the inherent restraints on local taxing authority. Taxpayers have relatively easy exit options should they find local tax rates too high, providing a significant practical check on local taxing authority. As scholar Richard Briffault observes, it is therefore “far from clear whether the extra constraint of state legislative and gubernatorial approval is necessary or desirable.”<sup>23</sup> Thus, granting localities the power to tax empowers local communities, and comes with significant non-legal constraints. But the lack of such authority leaves local governments unable to respond to constituent concern.

## Preemption and Local Fiscal Authority: The “New Preemption” Regime Depends on Limited Local Fiscal Authority

Much has already been said—in this white paper series and elsewhere—about the recent uptick in preemptive legislation across the country. But it is important to note that in addition to preempting local authority in substantive issue areas, states have also been active in preempting local authority to raise revenue at all. Moreover, some states have used punitive preemption laws to take away money otherwise allotted to local governments. Both of these trends threaten to further hamstring the ability of cities to respond to the needs of their citizens and to accomplish any new policy goals.

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Washington Institute of Public Policy, <https://www.lincolnst.edu/research-data/data-toolkits/significant-features-property-tax/state-state-property-tax-glance/glossary>.

<sup>17</sup> *Id.*

<sup>18</sup> *Id.*

<sup>19</sup> See Ariel Jurow Kleiman, *Tax Limits and the Future of Local Democracy*, Harvard L. Rev. (forthcoming 2020) (discussing the ways that tax limits undermine local public control), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3327952](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3327952).

<sup>20</sup> Cal. Const. art. 13A, § 3(a).

<sup>21</sup> Bert Waisanen, *State Tax and Expenditure Limits—2010*, Nat'l Conference of State Legislatures, <http://www.ncsl.org/research/fiscal-policy/state-tax-and-expenditure-limits-2010.aspx>.

<sup>22</sup> *Id.*

<sup>23</sup> Richard Briffault, *Home Rule for the Twenty-First Century*, 36 Urb. Law 253, 270 (2004).

### ***Recent Legislative Efforts to Restrict Local Fiscal Authority***

Restrictions on local fiscal authority have long been the norm, but state interest in regulatory preemption also seems to be influencing new efforts to restrict fiscal authority. Of course, this trend is hard to disentangle from general levels of support for anti-tax measures statewide. Take Texas, for example, which was recently at the center of a punitive preemption struggle over immigration enforcement.<sup>24</sup> Shortly after litigation challenging Texas' immigration law ended, the state legislature imposed significant limits on local property revenue growth, requiring jurisdictions to seek voter approval when property tax revenues are scheduled to increase by more than 3.5%, even if such increases are due to rising property values and not changes in tax rates.<sup>25</sup> While similar bills had been proposed for years in the legislature, nothing passed until 2019, and the growth rate restriction enacted is more stringent than several of the failed proposals had been.<sup>26</sup>

Other restrictions on fiscal authority may also be spreading. In 2016, voters in Missouri approved a constitutional amendment prohibiting any new sales taxation of services at the state and local level.<sup>27</sup> Going further, in 2018, Arizona voters endorsed a constitutional amendment prohibiting governments from either expanding sales taxes to cover new services or from increasing the tax rates on currently taxed services.<sup>28</sup> Given that the sales tax has eroded significantly as the U.S. has shifted increasingly to a service-based economy, economists and policymakers have long argued that the sales tax should more broadly apply to services.<sup>29</sup> Such prohibitions both limit local sales taxes directly and also may place pressure on intergovernmental aid by limiting state sales tax revenue as well. The Arizona Attorney General argued in litigation currently before the Arizona Supreme Court that Arizona's prohibition also applies to the user fees charged to transportation networking companies like Uber for their use of city-owned property.<sup>30</sup> Such an interpretation of Arizona's constitutional prohibition threatens not only the sales tax base but many of the user fees states and local governments rely on to supplement their limited taxing authority.

Finally, municipalities across Ohio are closely monitoring their challenge to the state's efforts to assert administrative control over an important municipal revenue base, the municipal net income tax.<sup>31</sup> Ohio's local governments have traditionally enjoyed significantly more fiscal authority than other jurisdictions, and they have long imposed

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<sup>24</sup> See Rick Su, *The State Assault on Local Sanctuary Policies*, <https://www.abetterbalance.org/wp-content/uploads/2018/11/Sanctuary-Cities-White-Paper-FINAL-11.1.18.pdf> (discussing various provisions of Texas's law).

<sup>25</sup> S.B. 2, 85<sup>th</sup> Reg. Sess. (Tex. 2019).

<sup>26</sup> Riane Roldan & Shannon Najmabadi, *Gov. Greg Abbot Signs Bill Designed to Limit Property Tax Growth*, Texas Tribune (Jun. 12, 2019), <https://www.texastribune.org/2019/06/12/abbott-signs-property-tax-bill-sb2/>.

<sup>27</sup> Mo. Const., art. X, § 26.

<sup>28</sup> Ariz. Const., art IX, § 25.

<sup>29</sup> See Ronald C. Fisher, *State and Local Public Finance* 367 (4<sup>th</sup> ed., 2016).

<sup>30</sup> Brief for Petitioner, *State ex rel Brnovich v. City of Phoenix*, CV-20-0019-SA (Arizona, Jan. 21, 2020).

<sup>31</sup> *City of Athens v. Testa*, 2019-0693 (2019).

their net income tax, an income tax on both individual and corporate income earned within the jurisdiction. Ohio's cities are concerned that state control over the administration of the tax would both compromise revenue from the tax and also represents a first step toward limiting local tax authority more broadly. Both the trial and appellate courts rejected arguments that these reforms violated Ohio's constitutional home rule provisions, and a decision from the Ohio Supreme Court is expected soon.<sup>32</sup>

### ***Punitive Preemption and Local Fiscal Authority***

Another increasingly common form of preemption is so-called "punitive preemption," where states not only preempt local authority on an issue, but also impose penalties on cities that pass potentially preempted policies. Where in the past states had found it sufficient to simply deny local governments the authority to act in a given issue area, more recently, state legislatures are increasingly debating (and passing) bills that limit local authority and also sanction local governments and local public officials that run afoul of state preemption laws.<sup>33</sup> Many of these sanctions are financial, with state laws imposing fines both on governments that adopt ordinances preempted by state law and on local officials who enforce these ordinances.<sup>34</sup>

Such punitive preemption efforts do more than dissuade localities from enacting potentially preempted policies; they even discourage localities from challenging the validity of the state preemption legislation itself. Consider, for example, Arizona's 2015 law imposing fiscal sanctions on localities. If the state's attorney general finds a city has adopted an ordinance preempted by state law, and the local government does not cure the problem, the attorney general is directed to suspend state shared revenue for the jurisdiction.<sup>35</sup> This fiscal sanction is significant. For example, for Tucson, the state's second largest city, state shared revenue represents about a quarter of its general revenue fund, a sum the city could not possibly make up on its own.<sup>36</sup>

Imposing fiscal sanctions along with preemption leaves cities doubly vulnerable. The costs of litigation may deter local governments from acting, especially given the knowledge that the sanctions make resistance self-defeating. Tucson's elected officials recently took a strong stance against the city adopting a sanctuary city ballot initiative precisely because they feared Arizona's fiscal sanctions.<sup>37</sup> Several states have similarly imposed fiscal sanctions for localities who violate state laws protecting Confederate monuments.

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<sup>32</sup> *City of Athens v. Testa*, 119 N.E.3d 469 (Ohio Ct. App. 2019).

<sup>33</sup> Erin A. Scharff, *Hyper Preemption: A Reordering of the State-Local Relationship?*, 106 Geo L.J. 1469, 1476–79; 1495 (2018).

<sup>34</sup> *Id.*

<sup>35</sup> See S. 1487, 52d Leg., 2d Reg. Sess. (Ariz. 2016); Ariz. Rev. Stat. Ann. § 41-194.01(A) (2016).

<sup>36</sup> Complaint at 5, *City of Tucson v. Arizona*, C20165733 (Ariz. Super. Ct. Dec. 12, 2016).

<sup>37</sup> Justin Sayers, *Tucson Voters Overwhelmingly Strike Down 'Sanctuary City' Proposal*, *Ariz. Daily Star* (Nov. 6, 2019), [https://tucson.com/news/local/govt-and-politics/tucson-voters-overwhelmingly-strike-down-sanctuary-city-proposal/article\\_7adf637c-0043-11ea-90b2-bf1099f7c8cf.html/](https://tucson.com/news/local/govt-and-politics/tucson-voters-overwhelmingly-strike-down-sanctuary-city-proposal/article_7adf637c-0043-11ea-90b2-bf1099f7c8cf.html/).

States have also practiced punitive preemption through retaliatory funding policies. Tennessee, for example, has done precisely this in its battle with Memphis over Confederate monuments. Because the state’s Historical Commission did not grant Memphis permission to remove its Confederate monuments, state law prevented Memphis from removing such monuments located on city property. As a workaround, the city sold the monuments and the city park land on which they stood to a private non-profit. While such actions complied with state law, the Tennessee legislature retaliated by withdrawing previously authorized financial support for Memphis-planned bicentennial celebrations.<sup>38</sup> While some city officials considered this a price worth paying,<sup>39</sup> the possibility of these kind of retaliatory funding cuts is cause for concern, and legal theories challenging the state’s actions are, at best, untested. The state’s discretionary spending programs are, after all, discretionary, and the legislature has broad authority to redirect such funding.

## Looking Forward: Increasing Municipal Fiscal Authority to Empower Local Democracy

While litigation, like that in Ohio, is important, increasing local fiscal authority will generally require legislation or constitutional reform. Local governments could seek authority to impose new types of taxes or they could shift their tax authority more broadly by seeking home rule authority over the taxing power.<sup>40</sup> In an era of rising preemption, such authority would necessarily still be limited. However, because it is always harder to pass legislation than to block its passage, this shift should still expand taxing authority by allowing local governments to be the first movers.

Although state restrictions on local tax authority have proved politically popular in many U.S. jurisdictions, a persuasive case can be made that cities need new sources of revenue. And cities are beginning to make this case. In Washington state, the Supreme Court has the opportunity to reverse an almost century-old precedent that income taxation violates the Washington Constitution’s uniformity clause, and thus clear the way for the implementation of Seattle’s progressive income tax,<sup>41</sup> and civic leaders in Chicago are also beginning to talk about a city income tax, though such a tax would require both a state constitutional change and legislative approval.<sup>42</sup> Such legislative reform and advocacy suggest change is possible.

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<sup>38</sup> Alan Greenblat, *This City Removed 2 Confederate Statues. Then The State Retaliated*, *Governing* (July 2018), <https://www.governing.com/topics/politics/gov-shelby-tennessee-confederate-statue.html>

<sup>39</sup> *Id.* (“Honestly, for me, if \$250,000 is the price for all of us to move on and be done, then hallelujah.”)

<sup>40</sup> See generally Erin Adele Scharff, *Powerful Cities?: Limits on Municipal Taxing Authority and What to Do About Them*, 91 N.Y.U. L. Rev. 292 (2016) for a more detailed discussion of this proposal.

<sup>41</sup> Daniel Beekman, *State Court of Appeals Rules Seattle’s Wealth Tax is Unconstitutional, But Gives Cities New Leeway*, *Seattle Times* (Jul. 16, 2019), <https://www.seattletimes.com/seattle-news/politics/state-court-of-appeals-rules-seattles-wealth-tax-is-unconstitutional-but-gives-cities-new-leeway/>.

<sup>42</sup> See, e.g., Ed Zotti, *A Chicago City Income Tax Could Be In Our Future Because Other Alternatives Are Worse*, *Chicago Sun Times* (Nov. 22, 2019),

## Postscript

In the wake of an unprecedented public health crisis, state and local governments will face fiscal strains for an, as yet, undetermined amount of time. Without the ability to engage in deficit spending and facing pressing human services needs and shrinking tax revenues, local governments have difficult decisions ahead. Intergovernmental aid is an essential part of our fiscal federalist system—always, but especially in recessions. But local governments also need flexibility to respond to changing fiscal landscape—current preemption efforts move local governments even further away from that needed flexibility.

When local governments emerge from this current crisis, it is quite probable they will continue to face the same challenges as before: pressing spending needs, decreased state support, and limited independent fiscal authority. Reforms that increase local fiscal authority are an important first step in facing those challenges.